CAPITAL BUDGETING

(100-71)

HEARING

BEFORE THE

SUBCOMMITTEE ON ECONOMIC DEVELOPMENT

OF THE

COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

DECEMBER 8, 9, 1987

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CAPITAL BUDGETING

TUESDAY, DECEMBER 8, 1987

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT,
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:14 a.m., in room 2167, Rayburn House Office Building, Hon. Gus Savage (chairman of the subcommittee) presiding.

Mr. SAVAGE. This hearing of the Subcommittee on Economic Development will please come to order.

This morning we meet for the first of two days of hearings on the subject of a capital budget for the Federal Government. This is an important matter, particularly because capital budgeting is one of the most often-mentioned proposals for reform of our increasingly complex and cumbersome Federal budget process.

The committee expects to carry these hearings over into the next session for at least one additional day to obtain a more complete record and discussion at a more appropriate time in the budget cycle.

In the 97th and 98th Congresses this committee examined capital budgeting as a decision-making tool and a first step toward providing the President and the Congress with a source of accurate and comprehensive information and data on the Nation's infrastructure. As a result of our efforts and those of the Committee on Government Operations, Public Law 98–501, the Public Works Improvement Act of 1984, was enacted. Title II of that law, the Federal Capital Investment Program Information Act of 1984, requires the President's budget to include projections of Federal investment spending and a review of assessments of public civilian investment needs. That information is now presented as a supplement to Special Analysis D of the President's budget each year.

Title I of the law established the National Council on Public Works Improvement, whose final report to the President and the Congress will be forthcoming in a few months.

However, more recent proposals for a capital budget within the Federal budget process involve issues broader in scope than those contained in the Public Works Improvement Act and could have a greater impact on legislation that comes before this committee.

Today's witnesses are representatives from the Congressional Budget Office and from the General Accounting Office. We did extend an invitation to the Office of Management and Budget; however, we were told that they are too busy to testify at this time. I would like to place in the record a copy of that letter.

[Letter referred to follows:]

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Committee on Public Works and Transportation
One Hundredth Congress
U.S. House of Representatives
Room 2165, Rayburn House Office Building
Washington, DC 20515
TELEPHONE: AREA CODE 202, 225-4472

November 20, 1987

The Honorable James C. Miller III
Director, Office of Management
and Budget
2510 Old Executive Office Building
Washington, D.C. 20503

Dear Mr. Miller:

As you know, since enactment of the Congressional Budget Act in 1974, the Congressional budget process has become increasingly complex and cumbersome. There is a clear recognition that the process needs to be improved. Among the proposals discussed for budget reform has been that of creating a Federal capital budget.

Because of the impact a capital budget could have on our Committee's legislation, our Members wish to get a better understanding of this concept. The Subcommittee on Economic Development has scheduled hearings for December 8 and 9, to learn more about the subject.

We would like you to testify before the Subcommittee on Tuesday, December 8, 1987 at 10:00 AM in Room 2167, Rayburn House Office Building.

It would be very helpful to hear the Administration's position on this method of accounting, your definition of a capital budget and your views on its advantages and disadvantages. We would also like to know how it would differ from current practices; what impact it might have on the Federal deficit, on Gramm-Rudman-Hollings, on Executive Branch and Congressional budget procedures, and on the formulation of national fiscal and monetary policies. In

addition, we are especially interested in the effect it might have on the process and decisions relevant to authorizing programs under our Committee's jurisdiction.

Should there be any questions about your participation, please contact Subcommittee staff, Carl Lorenz or Marti Downie, at 225-6151. We look forward to hearing your testimony and discussing the issues with you.

Sincerely,

Gus Savage
Chairman, Subcommittee
on Economic Development

Mr. SAVAGE. We will again ask for the views of that office when we continue hearings in the next session.

We are interested in knowing how one should define a capital budget in theoretical as well as practical terms and in hearing what is considered to be the advantages as well as the disadvantages of including a capital budget as part of the budget process. Many questions come to mind, such as: How would it differ from current practices? What impact might it have on the Federal deficit on Gramm-Rudman-Hollings, on Executive Branch and congressional budget procedures and on formulation of national fiscal and monetary policies?

Also, of course, what effect might it have on programs authorized by this committee, that is, our grant, loan and loan guarantee programs?

Incidentally, tomorrow we will hear from additional expert witnesses who will address various aspects of capital budget accounting procedures and provide helpful insights on the current practice and use of capital budgeting at the State and local levels.

Now, Congressman William Clinger of Pennsylvania, do you have opening remarks?

Mr. CLINGER. Thank you very much, Mr. Chairman. I am sitting in briefly for the ranking member, Mr. Shaw, who is expected here shortly. I want to thank you and thank him for convening this series of hearings on capital budgeting. I can't think of a more timely issue, especially in the current environment as we wait patiently for the House, Senate, and White House negotiators to complete their work.

I've come to learn that capital budgeting is a difficult issue to discuss around here from a marketing standpoint. It does not share the same attractiveness as do foreign assistance, defense or welfare issues. If you should be so bold as to attempt to sell the idea by couching it in terms of amending the current budget process, as cumbersome and as imperfect as it is, capital budgeting scares away many policy makers for fear that it will further obscure a process they've grown accustomed to criticizing and, perhaps, vaguely understanding.

But in my conversations with policy makers here in Washington, the biggest challenge I find is the need to overcome the uncertainties that arise when the subject of capital budgeting is raised. Frankly, I think the present budget fiasco begs Congress to adopt better methods of developing and implementing an improved budget process. My study of capital budgeting convinces me that this is one reform that, if implemented in a disciplined and well-thought-out manner, has great merit because it will have the beneficial effect of clarifying, not obscuring, our Government's spending practices.

The potential for improving information available to policy makers to help guide them during budget deliberations is tremendous. In its most elementary form capital budgeting segregates operational expenses from investment spending. Lawmakers would be able to distinguish how much of an agency's account is devoted to paying the bills and how much of its funding provides annual benefits.

Capital budgeting would provide a benchmark that policy makers could use to gauge past and present Federal investment in infrastructure, instead of today's practice of debating numbers representing an agglomeration of accounts that hold very little descriptive value about the real effects of cuts or increases. For those of us who subscribe to the belief that more resources must be brought to bear on our Nation's inventory of public works projects, I suggest that capital budgeting would aid us very much in this endeavor. With it we would be able to strictly monitor projects, programs and activities in a way that would permit Congress and the Administration to better allocate scarce Federal resources.

Capital budgeting, if done properly, is not an exercise in "cooking the books." Indeed, it would make such a practice much more difficult. There are some who oppose the idea for the fear that capital budgeting is an illusory gimmick that is designed to understate the deficit, and others argue that the Federal Government has no need for capital budgeting since we do not amortize investments. It is my belief that these arguments are misguided objections to what could be a major improvement in our budget process. I hope that as the debate on this and on budget reform progresses, policy makers will be more open to the idea of implementing this worthwhile practice.

Before closing, Mr. Chairman, I would like to advise members present this morning that I am prepared to introduce a bill later today that takes a first step in the direction of capital budgeting, building on the bill of 1984. It is identical to a measure already introduced by Senator Dan Evans, who will appear before this subcommittee tomorrow. The bill would require the White House—and only the White House—to employ capital budgeting in its budget submission to the Congress at the beginning of each year. It would continue the practice of a unified budget but would segregate, where possible, investment spending from operating expenses. No effort is made to impose such a practice on Congress at this time. It is the thinking that we would see what the experience would be with the White House required to provide a capital budget, and then build on that at an appropriate time.

It is my hope that members who are persuaded that capital budgeting is a useful tool would be willing to sign on as original co-sponsors of this bill.

So, Mr. Chairman, I look forward to today's witnesses testifying about the merits of capital budgeting and the drawbacks, if any.

Once again, Mr. Chairman, thank you for convening these hearings.

[Mr. Shaw's prepared statement follows:]

STATEMENT OF THE HONORABLE E. CLAY SHAW, JR.
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT
TUESDAY, DECEMBER 8, 1987
10:00 AM -- ROOM 2167 RHOB

GOOD MORNING, MR. CHAIRMAN. IT IS A PLEASURE TO BE HERE AND I WOULD LIKE TO JOIN WITH YOU IN WELCOMING OUR WITNESSES FROM THE CONGRESSIONAL BUDGET OFFICE AND THE GENERAL ACCOUNTING OFFICE.

THESE TWO DAYS OF HEARINGS ARE VERY IMPORTANT BECAUSE WE ARE ADDRESSING ONE OF THE MOST CRITICAL ISSUES ASSOCIATED WITH THE FEDERAL BUDGET; NAMELY, HOW WE ACCOUNT THE TAX DOLLARS THE TREASURY TAKES IN AND THE CHECKS UNCLE SAM WRITES.

MANY HAVE ARGUED THAT IT IS TIME TO RETHINK THE BUDGET'S STRUCTURE. I AGREE WITH THIS POSITION. TO ME, IT IS OUTRAGEOUS THAT WE RELY ON AN ACCOUNTING SYSTEM WHICH PROVIDES US WITH LESS INFORMATION THAN ONE WOULD NEED TO RUN A LOCAL GROCERY STORE.

SOMEONE ONCE SAID THAT FIGURES LIE AND ONLY LIARS FIGURE. AS AN ACCOUNTANT, I CAN SEE A CERTAIN ELEMENT OF TRUTH IN THAT STATEMENT.

IN SAYING THIS I DO NOT MEAN TO SLANDER ANYONE NOR INSINUATE THAT THERE IS AN INTENTIONAL OR DELIBERATE EFFORT TO MISREPRESENT THE TRUTH WHEN IT COMES TO THE FEDERAL BUDGET AND HOW WE SPEND MONEY.

WHAT I AM SAYING, THOUGH, IS THAT DISCIPLINE AND ACCOUNTABILITY IN THE MANAGEMENT OF FEDERAL FINANCES IS ESSENTIAL. IN MY VIEW, A CAPITAL BUDGET IS ONE OF THE BEST MEANS BY WHICH WE CAN CLEAN UP OUR BOOKS AND IMPROVE THE OVERALL DECISION-MAKING PROCESS.

A CAPITAL BUDGET WON'T, AND I REPEAT, WON'T ERASE THE DEFICIT. THE ONLY WAY TO DO THAT IS TO SPEND ON AN ANNUAL BASIS NO MORE THAN WE ARE COLLECTING.

A CAPITAL BUDGET WILL, HOWEVER, ENABLE US TO DISTINGUISH BETWEEN WHAT WE ARE EXPENDING ON FIXED, LONG-TERM CAPITAL ASSETS -- OR PERHAPS MORE APPROPRIATELY OUR INVESTMENT IN THE FUTURE -- AND WHAT WE ARE EXPENDING TO MEET OUR DAY-TO-DAY OPERATIONS.

THE FEDERAL GOVERNMENT DOES ITSELF A SEVERE DISSERVICE BY USING A CASH-BASED ACCOUNTING SYSTEM THAT FRONT-END LOADS THE COST OF MAJOR ASSETS SO AS TO CREATE A BIAS TOWARDS SHORT-TERM ACQUISITION.

MR. CHAIRMAN, I LOOK FORWARD TO THE COMMENTS WE WILL HEAR TODAY AND TOMMORROW REGARDING THE ESTABLISHMENT OF A FEDERAL CAPITAL BUDGET AND ITS IMPACT ON THE BUDGET PROCESS AND ON THE LEGISLATION AUTHORIZED BY THIS COMMITTEE.

THIS SUBCOMMITTEE HAS TRADITIONALLY DEMONSTRATED ITS LEADERSHIP WITH REGARD TO THIS ISSUE AND I LOOK FORWARD TO CONTINUING THAT FINE TRADITION.

WITH THAT, MR. CHAIRMAN, I YIELD BACK TO YOU.

Mr. CLINGER. Mr. Chairman, I ask unanimous consent that the statements of the Honorable John Paul Hammerschmidt, ranking minority member of the Committee on Public Works and Transportation; and the Honorable Helen Delich Bentley be inserted into the record at this point.

Mr. SAVAGE. Without objection, so ordered.

[Statements of Mr. Hammerschmidt and Mrs. Bentley follow:]

STATEMENT OF THE HONORABLE JOHN PAUL HAMMERSCHMIDT
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT
TUESDAY, DECEMBER 8, 1987
10:00 AM -- ROOM 2167 RHOB

CHAIRMAN SAVAGE AND MEMBERS OF THE SUBCOMMITTEE, I JOIN WITH YOU IN WELCOMING THIS MORNING'S WITNESSES FROM THE CONGRESSIONAL BUDGET OFFICE AND THE GENERAL ACCOUNTING OFFICE. EVALUATING THE USE OF A CAPITAL BUDGET BY THE FEDERAL GOVERNMENT IS AN IMPORTANT ISSUE AND ONE WHICH I THINK DESERVES THE ATTENTION OF THE ENTIRE CONGRESS GIVEN THE DAY-TO-DAY STRUGGLE OVER THE FEDERAL BUDGET.

BUT, TODAY'S HEARING IS MORE IMPORTANT THAN JUST THE FACT THAT WE ARE EVALUATING AN ALTERNATIVE BUDGET PROCEDURE. THESE HEARINGS ARE IMPORTANT BECAUSE THEY DEMONSTRATE THIS COMMITTEE'S CONTINUED LEADERSHIP IN THIS AREA.

AFTER YEARS OF DEBATE, THIS COMMITTEE INITIATED THE FEDERAL CAPITAL INVESTMENT PROGRAM INFORMATION ACT OF 1984.. THIS BILL MANDATED THAT FOR THE FIRST TIME A CAPITAL BUDGET MUST BE PREPARED TO IDENTIFY FEDERAL OUTLAYS FOR CAPITAL ASSETS AND DISTINGUISH THEM FROM THOSE FOR OPERATIONS. THE FACT THAT THE BILL'S SPONSOR IS REP. BILL CLINGER, A FORMER RANKING REPUBLICAN ON THIS SUBCOMMITTEE, SAYS A GREAT DEAL ABOUT THE IMPORTANCE THIS COMMITTEE ASCRIBES TO THIS ISSUE.

FURTHER, I KNOW THAT MR. SHAW HAS INTRODUCED LEGISLATION AND MR. CLINGER WILL SOON INTRODUCE A SIMILAR MEASURE, WHICH IF ADOPTED, WOULD REQUIRE THE IMPLEMENTATION AND USE OF A UNIFIED, CAPITAL BUDGET.

ONE MAY WONDER WHY THIS COMMITTEE HAS SUCH AN INTEREST IN THIS ISSUE. THE REASON IS VERY SIMPLE. THIS COMMITTEE IS CHARGED WITH THE RESPONSIBILITY OF INSURING THAT THE NATION'S INFRASTRUCTURE -- ROADS, BRIDGES, DAMS, PUBLIC BUILDINGS -- ARE PROVIDED FOR. TO DO SO, WE MUST CONTINUALLY FIND MEANS BY WHICH TO IMPROVE OUR DECISION MAKING PROCESS ABOUT THESE AND OTHER PROGRAMS. I BELIEVE, BASED ON WHAT WE HAVE LEARNED SO FAR, A CAPITAL BUDGET IS AN ACCOUNTING TOOL WHICH SHOULD BE USED TO HELP US IN EVALUATING THE FEDERAL GOVERNMENT'S INFRASTRUCTURE INVESTMENT AS WE MOVE INTO THE NEXT DECADE.

I AM SURE TODAY AND TOMMORROW'S HEARINGS WILL BE FRUITFUL IN GIVING US A BETTER UNDERSTANDING OF THIS ISSUE. I LOOK FORWARD TO THE TESTIMONY OF THE MANY WITNESSES. AND WITH THAT MR. CHAIRMAN I YIELD BACK TO YOU.

Rep. Helen Delich Bentley

Opening Statement before the

Subcommittee on Economic Development

December 8, 1987

Chairman Savage and Ranking Minority Member, Mr. Shaw, I commend both of you for arranging for this subcommittee hearing to review the advantages and disadvantages of establishing a federal capital budget and its impact on the budget process. During these times of budget restraints imposed by Congress, we need to carefully review alternatives to our budget process.

The Subcommittee on Economic Development has the responsibility of preparing and reporting legislation designed to direct economic development provisions as it pertains to public infrastructure and transportation services. Public transportation and infrastructure financing systems often require large budget proposals on the part of the federal government. Because of these demands on the federal government, development and implementation of a sound fiscal budget is imperative.

If we are to successfully meet future infrastructure demands federal budgets must not prevent identifying resources needed to meet the government's capital infrastructure needs. In making expenditures under a balanced budget proposal, infrastructure financing must receive necessary funding.

It is encouraging to participate in a hearing designed to examine legislative proposals affecting the federal government's budgeting process. I look forward to receiving the testimony provided to the subcommittee on this important issue. High domestic and trade deficits demand improved ways of creating a sound federal budget and accounting process. I offer my full support to my colleagues of the subcommittee in reviewing the testimony presented here today.

# # # #

Mr. SAVAGE. Congressman Boehlert?

Mr. BOEHLERT. No statement, Mr. Chairman.

Mr. SAVAGE. Thank you.

As our first witness today we want to welcome the Acting Director of the Congressional Budget Office, Edward M. Gramlich. Mr. Gramlich, if you like you can introduce your associate, Mr. Ehrlich.

TESTIMONY OF EDWARD M. GRAMLICH, ACTING DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY EVERETT EHRLICH, ASSISTANT DIRECTOR, NATURAL RESOURCES

Mr. GRAMLICH. Thank you very much, Mr. Chairman. To my left is Dr. Everett Ehrlich, who is the Assistant Director for Natural Resources at CBO. He supervised the report that we have just completed. It is entitled "Trends in Public Investment," which I will talk about in my report today. This other report was done for the Joint Economic Committee, but a lot of the material is common.

My statement consists of 12 pages. First, I would like to submit it for the record and I would like to read about half of it, including the important points, in order to expedite the proceedings.

I will focus on three issues.

Mr. SAVAGE. Without objection, so ordered.

Mr. GRAMLICH. First, what is Federal investment from a theoretical standpoint? Second, what do CBO's numbers show, that issue being essentially the substance of this report? And third, what are the implications for capital budget?

Federal investment is generally defined as an activity that creates assets that have value because they create future output and income. The National Income and Product Accounts, which I will call NIPA accounts, treat as fixed investment all expenditures on new business plant and equipment and the purchases of dwellings by households. But under current NIPA accounting, Government purchases of such long-lived facilities are not considered investment, even when they virtually duplicate commercial investments as do, for example, the assets of power marketing authorities. Even these Government assets are omitted because they cannot be clearly shown to generate net income as private investments are presumed to do. Many regard the exclusion of all Government activity from the investment category as unduly restrictive. On the other hand, economists and accountants do not agree as to what Government activities might be placed in this category. In our study we look at several possible definitions.

Beyond the issue of what would constitute Federal investment is the problem of calculating out what it is worth. A dollar's worth of Federal investment must be as good as a comparable dollar of private investment for the two to be counted equally. Construction costs often provide the best information for measuring the value of fixed facilities. Construction costs are used to measure the value of private investments in the NIPA accounts; this is a reasonable practice, since firms in the economy characteristically will not undertake investments unless their expected value exceeds their cost. But public investments are undertaken for social as well as economic reasons and therefore their costs may exceed their economic benefits, even though their social contribution may be substantial.

On the other hand, some private investments result in losses and others are subsidized through the tax system or other mechanisms. Allowing for such offsets, the assumption of parity between the costs and values of private and public investments may not be unreasonable.

A further measurement issue concerns depreciation. Rules for depreciating Government capital have not been established. Much Federal investment is in large fixed facilities, such as dams, that remain in good condition for most of their useful lives and that lack private counterparts or secondhand asset markets to help determine the rate at which they depreciate. Whenever possible we use two alternative depreciation rules to demonstrate the sensitivity of our results to these assumptions. One rule is the "straight-line rule" which writes off equal shares of an assets's value over the course of its estimated life, and the other is a "discard" rule that writes off the asset's entire value once it is withdrawn from service.

Some Federal activities that might qualify as investment, however, pose special problems. Depreciation of defense weaponry, for example, arises from both physical and technical obsolescence, but neither is clearly measurable. Widely differing practices exist for writing off past research and development efforts, and no practices exist for depreciating human capital were it to be included.

Finally, it is important to note that if certain activities were included in a definition of Federal investment, then our notions of private investment would have to change accordingly. For example, the assets subsidized by Federal infrastructure grants to State and local governments are already accounted for as investments by the State and local public sectors. Assigning some portion of those investments to the Federal Government because of its financial role would mean lowering our estimates of State and local assets dollar for dollar. Moreover, growing evidence suggests that these grants result in relatively little additional State and local investment, so it might be inappropriate to credit a share of this investment to the Federal Government based on the full value of the grants. Corresponding changes would have to be made in the rest of the NIPA accounts. If the Government's research and development or education and training expenditures were to be considered investments, for example, then the NIPA would have to treat comparable private expenditures as investment, which is not the current practice.

With that as a preface, let me turn to the numbers themselves. These are on Table 1 which follows page 4.

Mr. SAVAGE. Pardon me, Mr. Gramlich. The table to which you refer, Table 1, follows page 4, is that right?

Mr. GRAMLICH. It follows page 4 in your draft.

Mr. SAVAGE. Okay.

Mr. GRAMLICH. There are about five pages of discussion that explain that table. I am going to talk about the table directly to give you an idea of the kind of numbers that are in the report.

First, let me explain what our numbers do or do not represent. The numbers in our report are NIPA-based, meaning that they conform with economy-wide estimates of saving and investment. On the other hand, they are not directly comparable with the official budget numbers. Unlike the unified budget calculations, the

NIPA accounts do not include transfers of such assets as land or loans, but they do count both gross revenue and outlays in those areas where the current budget allows receipts to offset outlays. They also account costs when they are incurred, among other minor differences.

In fiscal year 1986, which is the main focus in this testimony, the NIPA budget deficit was $214 billion in contrast to the unified budget deficit of $221 billion.

Depending on what is included, gross Federal investment spending—shown in the left column of the table—may have been as little as $15 billion in the top row according to the most restrictive definition using only "Federally-owned physical assets of enterprises and civilian agencies, and military assets with civilian counterparts," or as high as $155 billion, the items in rows 1, 2, 3A and 4 are added together.

That is gross investment. If we were to go to a capital budget, which would treat the depreciation—a concept which is difficult to measure—as the current expenditure notion, then the relevant total for net investment is over on the right side of that Table 1. We have it shown there by two different methods of depreciation, as I just said, but the kind of numbers you get would vary between $1 billion, which is the low estimate for net investment in row 1, and $75 billion, which takes the high estimate for net investment in rows 1, 2, 3A and 4. The discussion in the text illustrates that there are several intermediate possibilities, but for your purposes gross investment could range between $15 billion and $155 billion, and net investment between $1 billion and $75 billion, depending on what is to be treated as capital investment and the method used for depreciating this investment.

Let me then turn to page 8 in your copy to the implications of these numbers for capital budgeting.

I will discuss three implications. One is the sensitivity of the results to the assumptions employed; the second is the implication of capital budgeting for investment choices, and the third is the meaning of the budget deficit under the unified and under the capital budget concept.

On the first issue, the sensitivity of the result while a variety of capital budgeting proposals exist, they generally share the requirement that the current unified budget be split into two main budget accounts: on the one hand, a capital budget that would include all investment spending, and on the other hand, an operating budget covering all other Federal expenses plus an annual allowance for the depreciation of Federal assets during the budget period.

The use of an annual allowance would reflect the fact that the true economic cost of using a long-lived asset is its depreciation, the loss in value as it becomes older or obsolescent. Such a capital budgeting system would make Federal budgeting more like that of firms which measure their current income after deducting depreciation of assets from revenue. Systems used by State and local governments, while a form of capital budgeting, typically do not budget for the depreciation of their assets.

The first implication of our report is that what such a capital budget might show would depend on a number of subjective assumptions regarding what capital is and how it should be meas-

ured. Since a capital budget would take gross spending on Federal investment out of the budget totals and put annual depreciation in its place, net investment would be approximately equal to the difference between the deficit in a capital budget and the deficit in our current unified budget. In other words, since total net investment for calendar year 1986 ranges from $2 billion to $75 billion, the Federal deficit in that year under a capital budgeting system might have fallen from $205 billion under the NIPA accounting system, under the unified budget, to roughly $130 billion, depending on the definition used.

The obvious implication is that what capital budgeting tells us depends on what is considered "capital" and how it is valued.

Now, the second implication of capital budgeting involves making investment choices. Critics of cash budgeting claim that it gives agencies the incentive to minimize current spending without regard to long-term consequences. Thus, agencies facing buy-or-lease decisions tend to favor leasing because of the lower initial outlay even though buying might be cheaper in the long run. This results in higher costs to future taxpayers. The CBO performed an analysis of these investment choices in 1983, and will quickly summarize that analysis by saying that this bias could be eliminated simply by requiring present value comparisons of the outlays in the various options.

Finally, let me say a word about the meaning of the deficit. Capital budgeting changes the meaning of the budget deficit. A deficit in the unified budget measures the overall spending impact of Federal programs on the Nation's demand for goods and services and foretells the Federal Government's borrowing requirement. A deficit in the operating account of a capital budgeting system—the difference between receipts from current taxes and current expenditures, including depreciation—is analogous to measures of saving by businesses and households. If the concern is credit markets, the unified deficit that we have now is the most indicative measure. If the concern is overall levels of saving and investment, the information found in a capital budgeting system can be the basis for helpful adjustments.

Mr. Chairman, that concludes my statement and now I am pleased to take any questions you have about it.

Mr. SAVAGE. Thank you, Mr. Gramlich.

I realize today that we are dealing with a rather complicated, if not esoteric, subject. I presume that accounts for the classroom that joined us leaving, rather than any lack of charisma on your part. [Laughter.]

Let me ask you, Mr. Gramlich, isn't the NIPA concept used largely by economists to provide aggregate indicators of economic activity for the U.S. economy?

Mr. GRAMLICH. Yes.

Mr. SAVAGE. Then how do you relate such aggregate focus, provided by the NIPA, to the more detailed and precise financial and accounting-type focus which would be required in capital budgeting?

Mr. GRAMLICH. That is a difficult issue, Mr. Chairman. The NIPA accounts focus, first, on overall levels of output, and secondly, on saving and investment. I think that one of the interests in

capital budgeting is to see if the Federal Government is making any investment. So the NIPA accounts are the natural translation mechanism when one is asked about public investment.

Now, the question that you raised is a more difficult one because the budget that is used for making decisions, the appropriations process for financial management in the Government, is—as you point out—a different budget. So in addition to the kinds of conceptual issues that we focused on in the report you would have a set of different measurement, and in part conceptual, issues as you tried to work out the capital budgeting analog to the present unified budget.

I suspect that the Office of Management and Budget would raise difficulties in that translation. I am not sure how complicated these difficulties are, but the whole matter is one that bears a lot of thought if there is any interest in moving to a capital budgeting system.

Mr. SAVAGE. May I continue that. Also, is it your position—your Table 1, following page 4—is it your position that the category "intellectual capital" which certainly would be far more difficult about which to be accurate than would the first category, "economic assets"— would it be your position that despite the lack of preciseness that may affect the intellectual capital interpretation, at least it will provide better guidelines than presently exist in terms of where we stand and what our needs might be?

Mr. GRAMLICH. I think that is right. The general tenor of our report is that this capital budgeting information on public investment is useful when deciding where the Government stands—indeed, where the country stands—in the amount of capital that it is accumulating. And certainly, an important item is intellectual capital. Investment in intellectual capital is more difficult to measure than any other concept in table 1, except defense assets (in line 2) and depreciation. Depreciation is certainly much more difficult: we used relatively arbitrary measures, although they were probably the best available.

Intellectual capital is one example of an important piece of information to have, but it is very difficult to know exactly how it would be integrated into a capital budgeting process. One might decide that even though it is important information a first attempt at a capital budget might omit that category (row 3 in the table) simply because the measurement of depreciation and so forth are so difficult. A whole series of decisions of that sort have to be made.

Mr. SAVAGE. Let me ask one last question for this round, or at least make one last observation.

I was not suggesting that because of the difficulty of the impreciseness of such a figure, that it should be left out until ways could be developed to make it more accurate. I was really getting at the point, would not capital budgeting apply to this category of intellectual capital? Perhaps provide an additional weapon in the arsenal of we who believe that the intellectual capital or educational programs of our Government should receive greater priority than presently? Would it not provide us with additional arguments because this concept of budgeting would make more apparent the

long-range effect of our programs for, say, post-secondary education and so forth?

Mr. GRAMLICH. I think it would definitely provide additional arguments. But one thing I should point out is that there is no reason why the appropriations process would have to—or indeed, should—change if we moved over to capital budgeting. So there would definitely be grist for additional arguments. But in terms of the actual politics of appropriations, that is something that bears further thought.

Mr. SAVAGE. Okay. Let me let it go at this point.

Congressman Clinger?

Mr. CLINGER. Thank you, Mr. Chairman.

Thank you, Mr. Gramlich, for coming here today and sharing your thoughts on capital budgeting.

It wasn't clear from your statement whether in general you favor pursuing the concept or not, and I wondered if you could advise us if the CBO has a position on the merits of this concept?

Mr. GRAMLICH. We do not have a position on that, Mr. Clinger. It raises so many difficult—and at the present time, very sensitive—issues. We see our role as showing the kinds of things that might be done and talking about the advantages of the notion of capital budgeting, which are that you receive better information on saving and investment, but also showing that there are many practical problems in moving to a capital budgeting system. I would rather not take a position because, among other things, there are so many possible proposals; some could make improvements in the budget process and some could definitely worsen it.

Mr. CLINGER. Have you had an opportunity to review the bill that was introduced by Senator Evans on the Senate side and the one which I propose to introduce here?

Mr. GRAMLICH. Briefly, yes, sir.

Mr. CLINGER. Your overall impression of that approach?

Mr. GRAMLICH. If you take the bill at its face value, as I understand it—I have seen a summary of it—it really does not change either the appropriations process or the present unified budget account. What it does do is ask for more information on the amount of asset accumulation we are experiencing in various categories. So I personally think that would be a step in the right direction.

In your statement you indicated that this may be a first step toward something bigger, so we would have to know what the ultimate agenda is. But I think as the bill stands now, it could be viewed as very valuable information.

Mr. CLINGER. One of the arguments that is always presented in opposition to the concept of capital budgeting is that it will instantaneously create a whole new constituency for increased public works expenditures. I know that's always the argument that Office of Management and Budget generally makes. But isn't it also true that without it we have seen a gradual reduction over the last 25 or 30 years in the amount of resources at all levels of Government that are being devoted to public works development? It seems to me that with a unified budget it's awfully easy to reduce the amount of resources devoted to public works expenditures when you have other, more compelling constituencies arguing for social welfare or programs. Wouldn't at least the prospect of capital budg-

eting give you the possibility of arresting that decline in the investment of resources?

Mr. GRAMLICH. I think you could certainly argue your position. On the one hand, the present accounting system that focuses on one-year outlays could be argued to influence against investments that might be cheaper in the long run because all of the costs are borne up front and you are penalized for all the costs. On the other hand, the argument is turned around under capital budgeting: in a capital budget the capital expenditures do not count; you are penalized only for your current depreciation. So the argument can be fought on either side. You could argue that the present unified budget system is biased against capital and that the other system would be biased for it. A sensible appropriations scheme could be married to a capital budgeting scheme, in order not to produce a bias either way.

You asked about the numbers themselves. In this document—in the summary figure on page xiv, we show a chart that goes back to at least 1975. It is hard to get information before that time.

In fact, if you take our broad notion of capital—that is, the notion of rows 1, 2, 3A and, 4 that I talked about in Table 1—you see healthy growth in real terms from 1975. Net investment goes from $22 billion up to the present level; that is, it is three times larger than in 1975.

Mr. CLINGER. That's at all levels of Government, or just the Federal?

Mr. GRAMLICH. This is Federal net investment. It is precisely the four categories that I mentioned in Table 1. The numbers will be a little different because the prices are different, but the categories are the same and the figures are consistent after you make that adjustment for prices.

There has been more than a threefold increase in a 12-year period, so there is a healthy rate of growth. I think you might be right in theory, that there is a bias against capital investment in the present system; in fact, we have seen quite a healthy rate of growth in that investment. Of course, there have been other factors. One of the categories is defense purchases, for example, that have grown for other reasons.

That would explain much of that. But even the non-defense categories are growing. Not at that rate, but they are growing.

Mr. CLINGER. And highways and bridges and modern sewer systems and so forth?

Mr. GRAMLICH. That is right.

Mr. CLINGER. When we called for submitting an expanded "Special Analysis D" in the 1984 act, what is your opinion of the utility of that analysis now? Has it really proven to be very effective?

Mr. GRAMLICH. As I understand it there are two pieces of special information that come out now; it is an add-on to Special Analysis D. One is the information that you directly called for in your bill, which is the forecast information, and the second is information that I believe is independently provided, which is depreciation of the investment there.

I think both of those pieces of information are useful. I think just the gross investment without depreciation could be argued as misleading because it gives a false impression of asset accumulation.

It is very important that if you have the gross investment you have the depreciation as well, and I would argue fairly strongly for keeping both.

Mr. CLINGER. One of the arguments for going to a capital budgeting concept is the fact that so many of the States presently have capital budgets and it makes their task very, very difficult when they're not able to know with any certainty what the Federal Government intends to do. We operate on a much different basis where we have stop-and-go financing for sewer projects, for example. Wouldn't the fact that we would be projecting our needs and expectations out in a Federal capital budget really be of tremendous help to the overall Federal system by giving States and localities a clearer idea of what they could count on, or not count on, in terms of their own planning purposes?

In other words, at the present time we have kind of a chaotic situation in terms of the Federal/State relationship because of the fact that you can't really rely on anything from the Federal Government for more than a year at the time.

Mr. GRAMLICH. You are right about that, Mr. Clinger, but the same problem exists with grants to State governments for noncapital purposes. The Federal budget process allows a number of last-minute changes that affect both the capital and the current accounts, and they all cause planning difficulties.

If the problem is stability in budgets in general, there are many ways to deal with that. Perhaps a capital budget would improve stability for the grant component of the Federal budget, but you would still have instability because of the way fiscal decisions are currently made, including several last-minute changes.

Mr. CLINGER. Thank you very much.

Thank you, Mr. Chairman.

Mr. SAVAGE. We have been joined by Congressman John Lewis of Georgia.

Perhaps you have a question, Congressman Lewis?

Mr. LEWIS. Thank you very much, Mr. Chairman. You will be pleased to know I don't have any questions.

Mr. SAVAGE. Thank you.

At this point I want to recognize the presence of, and to commend, the ranking member of this committee, my good friend and colleague, Clay Shaw, for stimulating the interest of this subcommittee into scheduling these hearings. Certainly, this is a difficult but necessary subject for our understanding because we certainly need to deal with this.

At this point, Congressman Shaw, would you like to make opening remarks and then go into questions?

Mr. SHAW. Yes, I would, Mr. Chairman. I would ask at this point unanimous consent to insert a prepared statement at the first part of the record of this meeting.

Mr. SAVAGE. Without objection, so ordered.

Mr. SHAW. I would like to make a few short comments and observations and then I have a question for the witness.

I come to this committee with a fairly unique personal background, having heretofore been the ranking Republican member of the Public Buildings and Grounds Subcommittee before moving

over to this subcommittee, and also as a Certified Public Accountant.

I've had great frustrations over the last few years at the decision-making process which is based upon numbers and how they impact on the budget rather than on common sense and how it will impact on the future of the country and future generations. Because of that I have been particularly interested in the whole process of accounting for the Federal Government. Mr. Clinger, who was the ranking Republican member on this committee before I was, was bringing about and promoting the concept of capital budgeting, which I've been very proud to continue to push forward. I hope that in 1988 we will be able to get a bill out that hopefully could be supported by the Administration and certainly by the committee and by Congress.

In making the arguments as to how the budget process and the deficit are impacting future American generations, no consideration is given to the fact that many of the Federal Government's expenditures are represented by assets owned by the Federal Government and, if properly accounted for, through generally accepted accounting principles as they would apply to the private sector, and in the deficit itself—whether it would be worse through the depreciation process or whether it would be a lot less—at least then we would have a fair measure of how the country is going.

We've all heard, particulary on this committee, many stories about the infrastructure of this country and how it is deteriorating. In large part we are living off the past and I think this is because of the archaic accounting process that the Federal Government continues to cling to.

I have a question, and it comes from page 10 of your statement, sir, which says at the top of the page, "agencies facing buy-or-lease decisions tend to favor leasing . . . even though buying may be cheaper in the long run. This results in higher costs for future taxpayers."

I agree with you up to that point. The next sentence, however, reads, "But CBO's analysis of these choices shows that the bias could be eliminated by requiring present-value comparisons of the two options."

Could you expand upon that and tell us how, in fact, this impacts upon decision-making?

Mr. GRAMLICH. How it is impacting on decision-making?

Mr. SHAW. Yes, sir. You said the bias could be eliminated by requiring present-value comparisons—or "would impact on it," I should say.

Mr. GRAMLICH. I feel more comfortable with "would."

We are trying to put the buy-or-lease options on a comparable basis, instead of comparing lease expenditures with multi-year buy expenditures. To obtain a comparable basis, the total expenditure needed to perform some function over a number of years is discounted to produce the present value, which I think would be consistent with generally accepted accounting principles. In other words, the expenditure is converted to a common, present-value basis. Then the multi-year lease expenditures, discounted by the interest rate, would be compared with the purchase expenditures that would be made at the outset.

Mr. SHAW. But that would not impact upon the accounting process or the deficit, would it?

Mr. GRAMLICH. Not necessarily. You could keep that system under a unified budget framework. And if the agency decides to buy, you would consider all of the expenses in the present year outlays.

But what we're saying there is that for investment decisions, that you would make this comparison and——

Mr. SHAW. Yes, sir. I hear you and I would like to agree with you, but what you're leaving out of your argument is politics, and the deficit is politics. You don't live in that world. We do, and the Administration does, and I think therefore we have to make the determination as to how these decisions are to be made, how they're going to show up in our budget, in our deficit, and start building a balance sheet for the Federal Government. And I think that's the fallacy of the argument.

I'm not making light of what you're saying because this is obviously the way decisions should be made, but this is not the decision that's going to be made and there's no way we can legislate the politics out of the process. We have to clean up the budget process to take the politics out of it so that we design our budget system in such a way so that what you are saying you would like to be determined actually shows up in the budget, so that the right decision is forced upon us by the way it's going to show up.

Mr. GRAMLICH. I certainly do not disagree with that.

Mr. SHAW. I said before that when you look at the 50 percent of the Federally-occupied space right here in the Capital Region that is leased, you know that every Administration—this Administration and all previous Administrations—have accepted the philosophy that "I don't want to buy a building to make the next Administration look good." We don't operate on ten-year cycles; we operate, actually, on one-year cycles in our budget process, so it makes it very difficult unless our accounting procedures are correct.

You have no problems with that statement?

Mr. GRAMLICH. No.

Mr. SHAW. Thank you, sir.

Thank you, Mr. Chairman.

Mr. SAVAGE. We've also been joined by the very active gentlewoman from Connecticut, Nancy Johnson. Do you have any questions?

Mrs. JOHNSON. Thank you, Mr. Chairman. I appreciate your convening these hearings because I think this is the substance of what we all loosely refer to as "budget reform." In the long run we have to be able, through our budget process, to understand more clearly and accurately what it is that we're doing with our money, and only if we do that are we going to be able to spend wisely and enjoy a reasonable tax base.

I just want to thank you for the substance of your testimony, for the fact that you've been involved in this issue now over a number of years and therefore have a perspective on it that is very valuable to us.

I also want to commend my colleague, Mr. Clinger, who has been a leader on this kind of "un-sexy" issue that doesn't attract much attention in the general public and yet, in the long run, would sub-

stantially improve our ability to plan for maintenance and preservation of infrastructure investments, as well as to make those wisely.

I have been reviewing your testimony. I have no questions at this time but I do appreciate the quality of your testimony and the Chairman's calling this hearing. Thank you.

Mr. SAVAGE. Thank you.

Also, from Illinois, Congressman Kenneth Gray.

Mr. GRAY. Well, thank you, Mr. Chairman. I apologize for my tardiness; I had a meeting this morning. I'm in the process of going over the testimony so I'll defer my questions at this time. Thank you.

Mr. SAVAGE. Thank you very much, Mr. Gramlich, for your very good testimony, and to you, Dr. Ehrlich, for joining Mr. Gramlich.

[Mr. Gramlich's prepared statement follows:]

Statement of
Edward M. Gramlich
Acting Director
Congressional Budget Office

before the
Subcommittee on Economic Development
Committee on Public Works and Transportation
House of Representatives

December 8, 1987

NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EST) on Tuesday, December 8, 1987.

Mr. Chairman. Last week the Congressional Budget Office (CBO) released a study of investmentlike activities in the federal budget entitled Trends in Public Investment. The report was requested by the Joint Economic Committee. Today, I am pleased to appear before this subcommittee to discuss the contents of that report and the implications the report has for a capital budgeting system for the federal government. I will limit my statement to three key issues:

- What is "federal" investment?
- What do CBO's numbers show? and
- What are the implications for capital budgeting?

WHAT IS "FEDERAL" INVESTMENT?

Investment is generally defined as an activity that creates assets that have value because they generate future output and income. The National Income and Product Accounts (NIPA) treat as fixed investment all expenditures on new business plant and equipment and the purchases of dwellings by households. But under current NIPA accounting, government purchases of such long-lived facilities are not considered investment, even when they virtually duplicate commercial investments--as do, for example, the assets of power marketing authorities. Even these government assets are omitted because they cannot clearly be shown to generate net income as private investments are presumed to do. Many regard the exclusion of all government activity from the investment category as unduly restrictive. On the other hand, economists and accountants do not agree as to what government activities might be placed in this category. In our study, we look at several possible definitions of government investment.

Beyond the issue of what would constitute federal investment is the problem of figuring out what it is worth. A dollar's worth of federal investment must be "as good" as a comparable dollar of private investment for the two to be counted equally. Construction costs often provide the best information for measuring the value of fixed facilities. Construction costs are used to measure the value of private investments in the NIPA; this is a reasonable practice, since firms in the economy characteristically will not undertake investments unless their expected value exceeds their cost. But public investments are undertaken for social as well as economic reasons and, therefore, their costs may exceed their economic benefits, even though their social contribution may be substantial. On the other hand, some private investments result in losses and others are subsidized through the tax system or other mechanisms. Allowing for such offsets, the assumption of parity between the costs and values of private and public investments may not be unreasonable.

A further measurement issue concerns depreciation. Rules for depreciating government capital have not been established. Much federal investment is in large fixed facilities, such as dams, that remain in good condition for most of their useful lives and that lack private counterparts or secondhand asset markets to help determine the rate at which they depreciate. Whenever possible, we used two alternative depreciation rules to demonstrate the sensitivity of our results to these assumptions. One rule is the "straight-line" rule, which writes off equal shares of an asset's value over the course of its estimated life. The other is a "discard" rule that writes off the asset's entire value once it is withdrawn from service.

But some federal activities that might qualify as investment pose special problems. Depreciation of defense weaponry, for example, arises from both physical and technical

obsolescence, but neither is clearly measurable. Wide ranges exist for writing off past R&D efforts (if scientific or intellectual capital is to be included under the rubric of "investment") and no practices at all exist for depreciating human capital, were it to be included.

Finally, it is important to note that if certain activities were included in a definition of federal investment, then our notions of private investment would have to change accordingly. For example, the assets subsidized by federal infrastructure grants to state and local governments are already accounted as investments by the state and local public sectors. Assigning some portion of those investments to the federal government because of its financial role would mean lowering our estimates of state and local assets, dollar for dollar. Moreover, growing evidence suggests that these grants result in relatively little additional state and local investment, so it might be inappropriate to credit a share of this investment to the federal government based on the full value of its grants. Corresponding changes would have to be made in the rest of the NIPA. If the government's research and development (R&D) or education and training expenditures were to be considered investments, for example, then the NIPA would have to treat comparable private expenditures as investment, which is not the current practice.

WHAT THE NUMBERS SHOW

Let me first explain what our numbers do and do not represent. The numbers in our report are NIPA-based, meaning that they conform with economywide estimates of saving and investment. On the other hand, they are not directly comparable with the official budget numbers. (Unlike the unified budget calculations, the NIPA do not include transfers of such assets as land or loans, but they do count both gross revenues and

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outlays in those areas where the current budget allows receipts to offset outlays, and also account costs when they are incurred, among other minor differences. In fiscal year 1986, for example, the NIPA budget deficit was $213.6 billion, in contrast to the unified budget deficit of $220.7 billion.)

With regard to investmentlike activities, the NIPA data on purchases of equipment and structures include only purchases with an expected life of at least five years, and thus include less than corresponding budget accounts. For example, budget data for highway spending include spending on administration, safety programs, maintenance, research, and so on, as well as spending on new construction, while NIPA data for capital spending on highways include only new construction, and any reconstruction that adds to the useful life of existing highways. Numbers in this testimony are calendar year numbers, not fiscal year numbers. Moreover, while the figures in our report were expressed in 1982 dollars to demonstrate historical trends, the numbers I am discussing today are for 1986 only and are, therefore, in 1986 dollars.

Depending on what is included, total gross federal investment spending in 1986 may have been as much as $15 billion or as much as $150 billion, as seen in Table 1. Net investment--that is, gross investment minus depreciation of past investments--may have been less than $2 billion or more than $75 billion. This wide range reflects the tremendous uncertainty regarding what should be counted as investment and how its depreciation should be measured.

Our study looked at five broad classes of federal spending that could claim to be investment in order to investigate the implications of different definitions.

TABLE 1. FEDERAL INVESTMENT IN 1986 UNDER DIFFERENT CAPITAL CONCEPTS (NIPA basis, in billions of dollars at current prices)

Capital Concept and Investment Type	Gross Investment, 1986	Capital Consumption from: Depreciation	Capital Consumption from: Discards	Investment Net of Depreciation	Investment Net of Discards
Economic Assets					
1. Federally owned physical assets of enterprises and civilian agencies, and military assets with civilian counterparts	15.1	13.9	10.4	2.0	4.7
Defense Assets					
2. Weapons systems and tactical vehicles	62.1	38.8		23.4	
Intellectual Capital					
3A. All federal research and development spending	52.3		29.1		23.2
3B. Commercially oriented federal research and development	16.8		5.4		11.4
Federal Capital Grants					
4. Federal capital grants to states and localities	25.6	12.8	1.9	12.8	23.7

SOURCE: Congressional Budget Office, based on *Trends in Public Investment* (December 1987).

NOTE: In addition, federal spending on education services in 1986 was $25 billion, some of which may qualify as investment in human capital.

Spending on economic assets, the first type of capital, includes services provided by the government that contribute directly to the nation's economy. Federal irrigation water, for example, is used in farming, municipal, and industrial applications. Other federal assets substitute for those that firms could rent to the government--office buildings, computers, and so on. This class of spending has possibly the clearest claim to be considered federal investment. As seen in Table 1, Row 1, gross spending in this category was $15.1 billion in 1986; net investment ranged from $2.0 billion to $4.7 billion, depending on one's choice of accounting techniques.

Spending on defense assets is undertaken to generate long-term services or benefits in the form of greater national security. It is impossible to place a value or a "price" on national security because it cannot be bought and sold by individuals. But the purchase of long-lived defense assets could be considered investment because of these benefits. Looking at Table 1, Row 2, we see that gross investment in such assets as weapons and tactical vehicles totaled $62.1 billion in 1986; net investment (after subtracting a depreciation charge estimated to be $38.8 billion for past investments) was $23.4 billion.

Spending on intellectual capital refers to research and development (R&D) spending, which (when successful) leads to new products or processes and creates future income, as does physical capital. On the other hand, the bulk of this spending is on military projects and prototypes that often use available technology rather than create new knowledge. Row 3A of the table shows that total federal R&D spending was $52.3 billion in 1986, although only $16.8 billion of this spending (shown in Row 3B) was commercially oriented. It is entirely unclear what useful lives (and therefore, depreciation rates) should be chosen for these assets. CBO adopted assumptions used by other researchers in the

field, and obtained results of $23.2 billion in net investment for all intellectual assets, of which $11.4 billion is for commercial uses.

Spending on capital grants supports investment by state and local governments for infrastructure and other physical assets. Table 1, Row 4, shows that these grants totaled $25.6 billion in 1986. The choice of a depreciation rule is most important in this area. If we deduct an equal annual share of the value of an asset (such as a road) over its estimated productive life, then net investment is substantially smaller--only $12.8 billion. If we deduct the entire value of the asset when it is withdrawn from service, then net investment was $23.7 billion. The difference between the two reflects the fact that many infrastructure assets--such as roads, airports, and mass transit systems--were constructed in the past few decades and are still in their useful lives.

Federal grants and loan subsidies for human capital finance training and education, which make workers more productive, as does physical capital. But economic advancement is only one goal of education programs; personal enrichment, social leadership and cohesion, or cultural awareness also are intended outputs. Thus, it would require a great leap to classify all spending on education as a form of economic investment. Such expenditures, therefore, were excluded from our calculations. Were they to be included, gross investment in human capital would have added $25.0 billion to federal investment totals in 1986.

Overall results. What is counted in the total for federal investment depends on which categories of spending are regarded as capital.

- If only economic assets are included, federal investment would be that shown on Row 1 of the table, that is, gross investment of $15.1 billion, depreciation ranging between $10.4 billion and $13.9 billion, and net investment between $2.0 billion and $4.7 billion. This is the lower range of federal investment found in the study.

- If spending on all fixed facilities and long-lived equipment were included, federal investment would include spending in both Rows 1 and 2 of the table. Gross investment would be $77.2 billion ($15.1 billion plus $62.1 billion), depreciation between $49.2 billion and $52.7 billion ($10.4 billion plus $38.8 billion to $13.9 billion plus $38.8 billion), and net investment between $25.4 billion and $28 billion ($2.0 billion plus $23.4 billion to $4.7 billion plus $23.4 billion).

- The largest measure of federal investment would include spending for intellectual capital and for grants to states and localities as well as for federally owned physical capital. Taking the lower measure (in Row 3B) for intellectual capital, this would put gross federal investment at $119.7 billion ($15.1 billion plus $62.1 billion plus $16.8 billion plus $25.6 billion). Taking the higher figure (in Row 3A) would give $155.2 billion ($15.1 billion plus $62.1 billion plus $52.3 billion plus $25.6 billion). For the higher of these levels of gross investment, depreciation could range between $80.2 billion (taking

the lower figure for depreciation on each of Rows 1, 2, 3A, and 4) to $94.6 billion (taking the larger figure for depreciation on these rows), putting the upper figure for net investment at between $61.4 billion ($2.0 billion plus $23.4 billon plus $23.2 billion plus $12.8 billion) and $75 billion ($4.7 billion plus $23.4 billion plus $23.2 billion plus $23.7 billion).

Thus the overall range of gross investment found in the study was from $15.1 billion for investment in economic assets to $155.2 billion for all investment concepts combined. Comparable depreciation estimates are a low of $10.4 billion for economic assets to $96.4 billion for all concepts, and net investment estimates range from $2 billion if only economic assets are counted to $75 billion for all concepts together.

IMPLICATIONS FOR CAPITAL BUDGETING

Identifying the investment component of federal spending raises a variety of issues related to capital budgeting. These include:

- the sensitivity of the result to assumptions employed;
- the implications of capital budgeting for investment choices;
- the meaning of the deficit under the unified and under the capital budget.

The Sensitivity of the Result

While a variety of capital budgeting proposals exist, they generally share the requirement that the current unified budget be split into two main budget accounts: on the one hand, a capital budget that would include all investment spending, and on the other hand, an operating budget covering all other federal expenses plus an annual allowance for the depreciation of federal assets during the budget period. The use of an annual allowance would reflect the fact that the true economic cost of using a long-lived asset is its depreciation that measures the loss in its value as it becomes older or obsolescent. Such a capital budgeting system would make federal budgeting more like that of firms, which measure their current income net of depreciation. Systems used by state and local governments, while a form of "capital budgeting," typically do not budget for depreciation of their assets.

The first implication of our report is that what such a capital budget might show would depend on a number of subjective assumptions regarding what capital is and how it should be measured. Since a capital budget would take gross spending on federal investment out of the budget totals and put annual depreciation in its place, net investment (gross investment minus depreciation) would be approximately equal to the difference between the deficit in a capital budgeting system and the deficit in our current, unified budget. In other words, since total net federal investment in calendar year 1986 ranged from $2 billion to $75 billion, the federal deficit in that year under a capital budgeting system might have fallen from $204.6 billion (NIPA basis) under the unified budget to anywhere between $202.6 billion and $129.6 billion, depending on the definitions used. The obvious implication is that what capital budgeting tells us depends on what is considered capital and how it is valued.

Making Investment Choices

Critics of cash budgeting claim that it gives agencies the incentive to minimize current spending, without regard to long-term consequences. Thus, agencies facing buy-or-lease decisions tend to favor leasing (because of the lower initial outlay), even though buying might be cheaper in the long run. This results in higher costs for future taxpayers. But CBO's analysis of these choices shows that the bias could be eliminated by requiring present-value comparisons of the two options1/.

Current cash budgeting, even if imperfect, requires comparisons of capital and noncapital options for each budget purpose. This requirement is most important in those programs where the competing capital and operational solutions are much wider than deciding to buy or lease office space. For example, the $25.6 billion in federal grants to state and local governments for infrastructure made in 1986 includes spending on new highways, airports, and mass transit systems. But improving transportation service requires comparing this new construction with the alternatives of increasing maintenance of existing facilities, subsidizing users, pricing airports or highways more efficiently during their peak-use periods, or simply assigning dedicated traffic lanes to buses and carpools. By allowing more capital-intensive solutions, a different budget treatment may invite a new source of bias into program decisionmaking. In fact, experience in federal programs shows that when these choices are restricted (whether by funding conditions, budget treatment, or any other factor), less efficient investment choices are made.2/

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1. See Congressional Budget Office, The Federal Buildings Program: Authorization and Budgetary Alternatives (June 1983).

2. See Congressional Budget Office, Federal Policies for Infrastructure Management (June 1986).

The Meaning of the Deficit

Finally, capital budgeting changes the meaning of the budget deficit. A deficit in the unified budget measures the overall spending impact of federal programs on the nation's demand for goods and services, and foretells the federal government's borrowing requirement. A deficit in the operating account of a capital budgeting system--the difference between receipts from current taxes and current expenses including depreciation--is analogous to measures of saving (that is, income not spent on consumption) by businesses and households. If the concern is credit markets, the unified deficit is the most indicative measure; if the concern is overall levels of saving and investment, the information found in a capital budget can be the basis for helpful adjustments.

Mr. SAVAGE. Now for our next witness we would like to welcome Frederick D. Wolf, Director, Accounting and Financial Management Division, United States General Accounting Office.

Mr. Wolf?

TESTIMONY OF FREDERICK D. WOLF, DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY JAMES KIRKMAN, ASSOCIATE DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT

Mr. WOLF. Thank you very much. I am accompanied by Jim Kirkman this morning; he handles our budget policy analysis activities in GAO, the conceptual issues.

Mr. Chairman, Carl Lorenz and Ed Feddeman, the people we've worked with, asked us when we testify today to see if we couldn't make a rather dry subject a little bit more sexy.

Mr. SAVAGE. Pardon me, Mr. Wolf. May I suggest that because of the well-detailed testimony you have submitted, perhaps you would rather simply have this written copy in the record, and if you would perhaps consider summarizing it.

Mr. WOLF. Will do.

Mr. SAVAGE. Thank you.

Mr. WOLF. I am pleased to be here this morning, Mr. Chairman, to discuss our views on the concept of capital budgeting.

And, Mr. Clinger, let me answer your question right up front—not only to discuss capital budgeting but to explain why we believe it is useful in making Federal budgetary decisions, and why I think it is a good idea for the Federal Government.

Before doing that, I'd like to focus on our Nation's most pressing budgetary problem—the Federal deficit, and how budget reform relates to it.

I think we all recognize that the number one problem facing our Nation is how to reduce the Federal deficit. The recent Congressional/White House negotiations illustrate the difficulty of making revenue and spending decisions today. Although some agreements were reached in cutting the deficit, I think the public and the financial markets will be carefully reviewing those decisions to be sure that they result in concrete rather than superficial improvements. Also, they are expecting more than short-term actions on reducing the deficit. They are looking for discipline and accountability in how we manage the Government's financial resources.

Therefore, in order to restore some degree of public confidence, we need to develop concrete steps for improving the way we budget. One such step is improving the budget's conceptual framework, structure, and numbers.

We believe it is time to re-think the budget's structure. Since 1969, the Federal Government has used a unified, cash-based budget which was created so that the President and the Congress could address the cash flow of the Government as a whole as well as in its parts. This budget structure generally has served the government and public well. However, it makes no systematic distinction between outlays for capital investments and those for current operations. We believe that such a distinction is important in order to provide a better and clearer understanding of the Government's

financial position and the true costs and benefits of its programs. This will ultimately lead to more informed budgetary decisions.

Let me just note the magnitude of Federal capital investments. In fiscal year 1986 we spent about $100 billion for capital asset acquisitions, and we spent about $40 billion on new loans. In total, that's about 13 percent of total outlays.

Under the current unified budget, a dollar spent is a dollar spent. The current budget treats outlays for capital and operating activities the same even though they are different in a key respect—capital outlays do not reduce the resource base of the Government the way that current outlays do because they represent asset exchanges. Under present budgetary scorekeeping, a $100 million expenditure to build a hydroelectric plant, for example, contributes to the deficit the same way as a $100 million expenditure for current military fuel costs which we're going to burn that year, even though the investment in the power plant is going to last for a long time.

Let me focus for a minute on what capital budgeting can do for us.

First, and probably most importantly, it can provide more deficit control options. Because the unified budget does not distinguish between the receipts and outlays for capital investments and those for current operations, it doesn't identify the deficit impact of those items. We can't identify what portion of the $221 billion deficit for 1986 was applicable to capital investments and what portion was applicable to current operations. As a result, Federal deficit control actions such as Gramm-Rudman-Hollings have no choice but to focus solely on the aggregate deficit totals. In this regard, the Federal Government is clearly way behind most of our States. Something like 34 of our States require their governments to execute balanced budgets. All but a handful limit that requirement to the current operations portion of the budget. Debt financing is permitted for their capital projects but is usually subject to separate State debt limitations.

At the Federal level we lack the distinction between capital investments and current operations and therefore we close off this option for targeting deficit reduction actions.

A capital budget would provide the Congress and the President with an additional basis, if they chose, for targeting areas for deficit reductions in times of deficit spending.

For example, deficit targets could be established for the operating and/or capital components as well as for the total budget.

Secondly, a capital budget would also help to eliminate the well-known budget process disincentives toward physical capital investment which makes it difficult for us to invest in productivity-enhancing capital assets. Because physical capital expenditures in a given year, under the current budget, are reflected as if they were costs incurred in that year, we take a large hit right up front. A capital budget would approach this differently. It would deal with it by using a different scorekeeping approach in that capital expenditures would be distributed in budget reporting over the useful life of the capital investment. The amount reflecting each year's cost would be reported in the current operations portion of the budget. This would put capital investment amounts on a compara-

ble basis with current operation amounts and eliminate the current budget bias against capital projects.

Thirdly, a capital budget would more accurately report the costs of the Federal Government's direct loan programs, a subject of a great deal of debate over the past year. Under the current unified budget Federal loans are reported as cash outlays in the year that they're made. Capital budgeting would overcome this distortion by reporting in the current operations portion of the budget the annual net cost of the loan programs and reflecting loan outlays and receipts in the capital or financing portion of the budget. This would put loan program costs on a more comparable basis with grant program costs.

Further, this treatment would provide another benefit. It would reduce the incentive to undertake loan asset sales and other asset sales mainly to reduce the short-term deficit, something a lot of people liken to selling your garage in order to reduce your home mortgage.

Fourthly, a capital budget would start providing a link to agency-level and Government-wide financial statements, something that Mr. Shaw has talked about and introduced some legislation on and something that we have worked on at GAO for a number of years.

Lastly, a capital budget would also help to focus public attention on the Nation's physical infrastructure needs, a subject which this committee is very familiar with.

Let me now talk about the structure of GAO's capital budgeting proposals. Let me emphasize a couple of things right up front.

First of all, our proposal for restructuring the budget would result in the continued reporting of receipt and outlay totals for the Federal Government as a whole. Our unified restructured budget would, however, identify the operating and capital components of the unified budget totals. It would, therefore, maintain the unified budget's comprehensive coverage.

A budget restructured along these lines, as I indicated earlier, would permit budget balancing targets to be focused on current operations, capital investments, or both, if that's what Congress and the President so desire.

We've brought a couple of charts with us that might illustrate our unified restructured budget.

This first chart—let me call it Chart 1, which corresponds to attachment 1 of our written statement—is the current budgetary approach which we follow in the Federal Government. The budget, although it's a book that's two or three inches thick and has thousands of lines in it, essentially deals with three things: revenues, expenditures, and a deficit number, the total amount that we borrowed. Now let me refer you to Chart 2 which presents our unified restructured budget. When we talk about capital budgeting we're talking about a budget which deals with an operating budget, consisting of revenues and outlays, and you'll notice a line, "capital consumption charge." That's what Ned Gramlich was calling depreciation. And an operating deficit number, and then a capital budget which deals with capital revenues, capital investments, and a capital financing requirement. In other words, that's the amount of money we need to raise to invest in those capital investments. And then, obviously, there's an item that does not impact on bor-

rowing, and that's depreciation. Adjusting for that gets you down to the $220 billion number, which is the deficit as currently defined but as we've called it, and more appropriately, "total financing requirements."

Now, we've got two charts over on the other side which presenting greater detail the operating budget—Chart 3—and the capital budget, which is Chart 4. Those are merely details of what is considered in Chart 2. And if you will look, when we talk about capital investments we're talking about loan programs as being investments and physical additions, capital additions, the $106 billion.

Let me just do one other thing. This number is the one that Gramm-Rudman deals with, Chart 1. That's the deficit number that we just finished. If you come over here——

Mr. SAVAGE. Are we having problems with the reporter?

I want your testimony to be very clear on the record, sir.

Mr. WOLF. That's all right. We'll take care of it when we type it up later on.

If you look at 1987, that same bottom number, $149 billion——

Mr. SAVAGE. Pardon me for a moment. May I suggest that, if the audience will permit, you pull those boards closer to you so you won't have to leave the microphone.

Mr. WOLF. That's all right. I'm not going to go back over there again.

But I would just point out that this is the number that we've been working with in Gramm-Rudman all the time. If you begin to look at capital budgeting, this number for capital financing requirements is probably not a great deal different in 1987 than 1988. We don't have all these details yet; all we know is the $149 billion total.

Now, let's just speculate—because that's all any of us can do right now—as to what the impact of capital budgeting is on the picture of what our Federal Government is doing right now.

Mr. SHAW. Mr. Chairman, because of the complexity of the figures would it be possible for us to ask questions, perhaps ask the witnesses as we go along?

Mr. WOLF. Let me just do one thing, because I'm essentially finished other than to say that there are two areas that a lot of questions get asked about. One is, what's the definition of capital investment? The second is, how do we control them?

Our basic definition that we've used in putting these together is that capital assets are physical, tangible, have a life of more than a couple of years, and are owned by the Federal Government, or are clearly in the public domain if we don't technically own them; for example, the highways. And then loan programs—well, we said those are essentially the same. You need to have a clear definition if you're going to deal with capital budgeting, something that we all agree on. And secondly, you've got to have some kind of discipline either through auditing or some other approach to make sure that we don't cheat, all of us, on what goes into capital.

I'm going to stop at that point. Essentially, we're through, and we'll be glad to answer any questions that you might have.

Mr. SAVAGE. Let me start, Mr. Wolf, with the last thing you mentioned.

Mr. Gramlich before you referred to "intellectual capital," as you recall. You were saying "something physical, tangible," and so forth. Are you excluding intellectual capital?

Mr. WOLF. I'm not excluding intellectual capital from what you and I consider investment. But in all of our discussions with people about capital budgeting and some of the problems and concerns associated with it, almost everybody has said, you're right, that's an investment, but we shouldn't try to account for it the way we do physical capital.

One of the things, though, that we need to be very clear on is that that is also investment. That's the case. But we did not include it in these numbers.

Mr. SAVAGE. Well, that could become a very serious difference, because I understand that under capital budgeting capital investments would in effect be deducted from our deficit calculations, right? At least a portion thereof?

Mr. WOLF. No, it wouldn't. We're not saying you would deduct it from your deficit calculations or give it any kind of preference or say that it should not be controlled or that we should try to get it down to zero or anything like that. What we're saying is that you have the option of deciding on what you want to target to get down closer to zero.

Mr. SAVAGE. No, what I mean is that in the capital budgeting concept you would have to do something with your continuing assets, right?

Mr. WOLF. Yes.

Mr. SAVAGE. Your out-year values. Wouldn't that have the effect of being deducted from the current year deficit, as in regular accrual accounting methods?

Mr. WOLF. Yes, it would. Through the depreciation charge, your capital assets are charged over their life to the——

Mr. SAVAGE. Now, would there be any difference in the area of intellectual capital as a category? Differences there could have, you see, a great effect on what you give as your deficit numbers for a particular year. That could be a very serious difference, right?

Mr. WOLF. That is probably one of the two or three toughest issues for people to deal with, yes.

Mr. SAVAGE. Now, I would ask you also, would capital budgeting encourage budget—I don't know if the best word is "chicanery"—but budget manipulating, the manipulating of budgetary figures, especially with regard to how the deficit is reported and what we classify as capital, as indicated by your response to my question on intellectual capital? That is, not only what categories you use but even how you make definitions within that category. Would that possibly create great confusion? And in the political sphere, which is very important—as Congressman Clinger indicated—since we legislate based upon these figures, wouldn't that exacerbate the differences that already exist between us on the political side regarding the deficit?

Mr. WOLF. Actually, I don't think it would. For one thing, this issue is something that most of the State governments have struggled with for the past 10 years. They have found that they can deal with it by having an agreement and some clear standards as to

what capital is and then, in fact, making sure that those definitions are consistently followed.

The best example of why we don't think that's a problem is that in States where it has been done, it has not been a problem.

Mr. SAVAGE. But any degree which you go toward capital budgeting would have a negative effect on our budget figures, right? Because to the degree that you depreciate, you would have a negative effect on the deficit figures based upon our current unified budget, right?

Mr. WOLF. No. No, in the long run it doesn't. In your operating deficit you do have to charge some kind of depreciation because we're using up those assets that we've invested in over the years.

Mr. SAVAGE. Which is only a portion, however, of the total value.

Mr. WOLF. That's right. That's right. But then in terms of looking at our total borrowings, which is the last line, that's added back so that it doesn't increase the total deficit. You put it in, and then when you say, "That's my operating cost; now, what's my borrowing," well, I didn't have to borrow for that so I put it back.

Mr. SAVAGE. I see.

Congressman Shaw?

Mr. SHAW. Thank you, Mr. Chairman.

Looking under your capital budget account you've got capital revenues, and I can see that you deducted them from capital investments because in that they had been previously capitalized—they would have to be written off of the books. So you would be taking things from capital investment over to your revenues, and you would actually be decreasing your total assets by that amount—no, you'd be converting your capital into cash on your balance sheet.

Mr. WOLF. Let me bring you over to Chart 4, which is on the other side. You can see that most of that thing called "capital revenues" is loan repayments, where we're saying that loan repayments are not an operating revenue but rather just an asset transaction——

Mr. SHAW. I thought that's what I said. You're taking it from your capital investment——

Mr. WOLF. That's right.

Mr. SHAW. You capitalized it, so now that it's paid back you're taking it out of capital investment—

Mr. WOLF. That's right.

Mr. SHAW [continuing]. So that's where you come up with your net capital, which you've got labeled as a capital financing requirement. That would be a net figure.

I see you have also set up your depreciation of $50 billion, which I assume is a figure you just pulled out of the air. Is that right?

Mr. WOLF. It's a little more than that, but it's not something that we've got hard and fast numbers for right now.

Mr. SHAW. Do we have any idea what that figure would be if we did properly capitalize the entire inventory of capital assets in the Federal Government?

Mr. WOLF. We don't think that that's far off. It might be $60 billion, but it's somewhere in that neighborhood.

Those numbers, by the way, are not a great deal different than the numbers that CBO has put together.

Mr. SHAW. Okay.

Now, in comparing your total financing requirement of $220 billion, was that the deficit?

Mr. WOLF. That's what we used to call the deficit, yes.

Mr. SHAW. Unfortunately, that's what some people in high positions still call it, the deficit.

But if you were to put together an honest accounting system for the Federal Government, is it correct that you would have to take that $220 billion and deduct from it your capital financing requirements of $112 billion and come up with a much reduced figure?

Mr. WOLF. Well——

Mr. SHAW. Am I following you correctly on that?

Mr. WOLF. Sort of. From an operating standpoint, which is what most people figure to be your deficit or your net cost, deficit in the general parlance means something like what it cost me to do something——

Mr. SHAW. It's a cash flow statement, that's what it amounts to.

Mr. WOLF. This is a combination. It costs us $158 billion to run our Government this year. We had to borrow an additional $62 billion net to finance all of our investments, so our total borrowing is $220 billion. It's a little bit like saying—if you put it in terms of you and me, if I take my salary and I pay my grocery bills and my heat and my lights and all the other things that I do to live this year, I've got some money left over, hopefully. If I buy a house—let's say I make $50,000 and I spend $40,000 on living, so I've got $10,000 left over. So my operating budget is $10,000 surplus.

I buy a house this year, and the house costs another $40,000. Well, in that case I have to borrow $30,000. That's what this thing is showing. Living cost us $158 billion. Buying houses cost us $112 billion, but you wouldn't say that you lost $30,000 in this year under the scenario that I gave you. What you would say is, I made $10,000, then I invested $40,000, so I had to borrow $30,000. But you expect that house to last for a long period of time.

Well, in its simplest form, that's what we're trying to get to, to say, "What did it cost us to live, for the entire Government?" And on top of that, what did it cost us to invest? And the sum of those two is the total amount we borrowed.

Mr. SAVAGE. Would the gentleman yield?

Mr. SHAW. Yes, I'd be glad to yield.

Mr. SAVAGE. That's the point I was trying to get at. Using the simple example you gave about yourself, in effect you say that you commit yourself to $30,000 more than your income that year.

Mr. WOLF. That's right.

Mr. SAVAGE. However, there is an asset involved that is worth, let's say, $40,000 which—not counting interest and so forth—would bring you back to not having a deficit at all in your personal expenditures, right?

Mr. WOLF. That's right.

Mr. SAVAGE. Now, applying that to the present Federal deficit, doesn't that take off some of the pressures we are presently experiencing to reduce that deficit?

Mr. WOLF. Yes—well, if people begin to understand that maybe it makes more sense to balance our operating budget and not try to balance that $30,000 with money coming in this year. In other

words, if you put on your personal level again, why should we not buy the house just because we don't have cash coming in this year?

Mr. SAVAGE. Okay. Thank you.

Mr. SHAW. Let me take this just a little bit further.

The cost of borrowing the money is the interest, of course, which in our example up there that is already included in the $981 billion, in your operating expenditures. So then wouldn't it be correct, under the figures that are on the board, to say that our deficit, instead of being $220 billion in 1986, was $110 billion?

Mr. WOLF. If you take the interest out of there.

Mr. SHAW. Wait a minute. Isn't the interest in the $220 billion?

Mr. WOLF. Interest is in the $220 billion.

Mr. SHAW. All right. So what I did was deduct your $112 billion from the $220 billion, and that's where I came up with $110 billion. Now, I don't follow you when you say that interest is not in there.

Mr. WOLF. No, no. Interest cost, which is about $140 billion for the Federal Government this year——

Mr. SHAW. But isn't that in the $981 billion?

Mr. WOLF. That's included in the $981 billion, yes.

Mr. SHAW. Which is included in the $220 billion?

Mr. WOLF. Yes. That's right.

Mr. SHAW. So it is in there?

Mr. WOLF. Yes.

Mr. SHAW. So the real deficit is $110 billion?

Mr. WOLF. No——

Mr. SHAW. Correct me.

Mr. WOLF. Interest—we have to pay that every year. What we are taking out down there in the capital financing requirements is not interest at all; it's just the cost of acquiring those assets.

I'm sorry, we're not on the same wavelength.

Mr. SHAW. Well, is your capital investment a real figure of $149 billion?

Mr. WOLF. Yes. Yes. I mean, the numbers are a little tough to come by but yes, those are real numbers.

Mr. SHAW. So the interest expense—whether that came from taxes or whether it came from borrowing—is already in the $220 billion?

Mr. WOLF. Yes, but it's not in the $149 billion. The $149 billion is not interest cost on those investments. It is strictly what we paid to buy those buildings and those airplanes and all of the different things.

Mr. SHAW. I understand that. Maybe someone else could come and explain it to me from a different direction because I can't make that connection. I still see $110 billion as the real deficit amount.

Mr. BALLENGER. Would the gentleman yield?

Mr. SHAW. I'd be glad to.

Mr. SAVAGE. Congressman Cass Ballenger.

Mr. WOLF. Yes, sir.

Mr. BALLENGER. Over on the other chart where your interest is listed as $136 billion, is that an operating expense?

Mr. WOLF. That's right.

Mr. BALLENGER. So you can't pull it out. It's part of the deficit, no matter what happens. It is an operating expense.

Now, the $50 billion that you've got in depreciation——

Mr. SHAW. Excuse me, but that's in the $981 billion, and it's in the $220 billion. So why do I have to take it out twice? It's already in there. It's in the deficit figure.

Mr. BALLENGER. The $220 billion is a net figure, though.

Mr. SHAW. Well, I'm trying to get a net by saying that the $112 billion, which is your net capital—net increase in the Federal capital—that interest is already in the $220 billion, so why am I going to put it in there twice?

Mr. SAVAGE. Would the gentleman yield?

Mr. SHAW. Yes.

Mr. SAVAGE. Would you, Mr. Wolf, define capital financing requirements?

Mr. WOLF. Capital financing requirements is the $112 billion which is over here on Chart 4. It consists of some collections on loans, $20 billion; $16 billion of taxes, and that's essentially your highway tax fund; and then we made loans of $42 billion, and we made capital additions for highways, for buildings, for major weapons systems, etc.——

Mr. SAVAGE. Excuse me. What you're saying, then, is that interest repayments are not included?

Mr. WOLF. Not in that one, no.

Mr. SAVAGE. In the $112 billion, too?

Mr. WOLF. That's right. They're not in the $112 billion number anywhere. They're over here if you look at Chart 3, on the operating side, interest of $136 billion is included up at the top.

Mr. SAVAGE. And is all of that included in the $981 billion? That's the same thing I hear Congressman Shaw—you see, if all of that makes up the capital financing requirements, the $112 billion, too, is all of that included in the $981 billion?

Mr. WOLF. No. None of this is up here.

Mr. SHAW. I know that.

Mr. SAVAGE. Well, excuse me. It is in there, and that is now—well, wait a minute.

Are the figures where your hand is, your operating revenue and operating expenditure, are those the figures under the present accounting system? Oh, that's where I'm wrong. Okay. I'm sorry.

Mr. WOLF. So you come up with an operating deficit of $150 billion, capital financing of $112 billion, then a non-cash charge of $50 billion, that's your $220 billion.

Mr. SAVAGE. I see. Okay. I was thinking that the top figures were the cash-type accounting.

Mr. WOLF. Carl suggested that we make it sexy; what he didn't ask, fortunately, was to make it uncomplicated.

Capital budgeting is not something—you know, you can't just say outlays and receipts and one number. It is somewhat more difficult. I would suggest that the Federal Government is more difficult than just three numbers, which is what we deal with today. But we're kidding ourselves, in fact, if we think it's only three numbers.

Mr. SHAW. But you do come up with the same figure of $220.7 billion under both methods.

Mr. WOLF. Whether we use capital budgeting or what we do today, the total amount we borrow is the same. But the importance

of it, if you think bottom-line-types of things, which should Gramm-Rudman focus on? Operating or borrowing? That's what's driving us right now. Gramm-Rudman is saying, don't borrow a penny. Gramm-Rudman is saying in—what, 1992? I think that's the year that the zero comes up——

Mr. SHAW. Yes.

Mr. WOLF [continuing]. In 1992, under Gramm Rudman under today's budgeting concepts, we won't borrow a penny. And if anybody thinks that we can run the Federal Government without borrowing a penny, I think they're kidding themselves.

That's one of the problems. Everybody says, we've got this horrible deficit number, and yet we're not having some of the problems that you normally associate with a deficit. We think that this is one of the key reasons why.

Mr. SHAW. What is the real deficit?

Mr. WOLF. The real deficit? I'll give you how I would answer that, and I'll answer it a little bit as an individual, although this is a GAO position. But our deficit is something like $150 billion—using 1986—our deficit is about $150 billion to $160 billion, not $220 billion. And then what I said is, if you take the $149 billion and you start looking at the capital investment—and let's assume for a minute that we're generous and instead of a $62 billion difference, it's maybe only $50 billion—you take $149 billion, and our operating deficit is probably below $100 billion already.

Mr. SHAW. One of the beauties, too, of the process that we're talking about is that if we did have capital budgeting, where you say that the real deficit is around $150 billion, if decisions were made under capital budgeting it would probably be a lot less than that.

Mr. WOLF. Yes, maybe. Maybe.

Mr. BALLENGER. Mr. Chairman, if I may.

How can you say that the deficit is $150 billion, the operating deficit? I mean, the choice of the word "operating" implies exactly what you're talking about, but the real deficit is the amount of money that you have to spend to operate in that year, whether it's an operating or a capital outlay—I'm talking as a business person in those instances where you're going to buy a plant or you're going to buy machinery. Those are actual expenditures that you have to pay back.

Mr. WOLF. I don't want to portray the Federal Government as being the same as a business because it isn't; there are some major differences. But if you go to a business and you try to liken this to a business, the bottom line of what they call an "income statement" which is what it costs them or the profit they made, that's the $158 billion number.

Mr. BALLENGER. Right.

Mr. WOLF. Then they have a separate schedule called a "funds statement" where they say, "All right, I've got so much money"—because hopefully they made a profit—but, "I made so much money; now, here's what I did in investments." They don't call the $220 billion number their deficit or their loss. Let's equate the word "deficit" to the word "loss" if we're talking of business. They do not equate the $220 billion to their loss. They equate the $158 billion to their loss for the year.

Mr. BALLENGER. If I may, one more question.

Mr. WOLF. Yes.

Mr. BALLENGER. The $50 billion that you have registered as depreciation is unfunded. Is that just a bookkeeping figure——

Mr. WOLF. That's right.

Mr. BALLENGER [continuing]. So under an operating expense budget for a business person, that $50 billion would be written off, whereas in this example it's pure and simple bookkeeping.

Mr. WOLF. No, it's—what we've done with depreciation here is exactly the same thing, if you want to put it in business terms, that a business company does in preparing their financial statements. They charge their operations, or their current year, for the current year's portion of the usage of their assets. And then when they figure out how much they had to borrow, they say, "Well, yes, I actually had more cash than what my operating statement shows." So therefore they add it back.

Mr. BALLENGER. Yes, but the basis of paying taxes, that is the only reason a business would be interested in depreciation—because it is a tax-deductible expense. Since the Federal Government doesn't pay any taxes, we have to approach this situation with a different outlook.

Mr. WOLF. I would disagree with you. I think that the reason that they look at depreciation is because that is the best representation that anybody's come up with of the usage of their assets over a period of time, and that's why they charge it. It's also nice that it is deductible as a tax expense because in fact you're using something up. But depreciation is not driven by whether it's tax-deductible; it's driven first by the conceptual fact that you're using your assets, and then the tax code lets you deduct that.

Mr. BALLENGER. I thank the gentleman.

Mr. SAVAGE. Would you allow me just one more question, Congressman Shaw?

Mr. SHAW. Yes.

Mr. SAVAGE. On this point, Mr. Wolf, you say that in your estimation the actual deficit in 1986 would be closer to $150 billion. What impact does that have on the national debt of almost $3 trillion?

Mr. WOLF. It will not change the debt, because no matter which way you account we did borrow $220 billion last year, in 1986. We did borrow the $220 billion, and our $2.3 trillion debt is debt that we owe to other people. It's actually less because some of it is in fact owed to the Federal Government for some of the trust funds. But essentially, this won't change the debt number that's out.

Mr. SAVAGE. But what I was getting at, using your analogy to a private business in determining the situation in which you really find yourself—that is, the difficulty that would be looked at by a backer in the case of a request for a commercial loan, where you balance assets off against debt in order to determine your net worth—that would not be applicable in the case of the Government, you're saying?

Mr. WOLF. No. We have said that not only do you want to go to capital budgeting, but you also want to begin to use financial statements so that when you look at the $2.3 trillion debt that we owe,

you also have some idea of what the assets are that we own. The same thing that the banker does, yes.

Again, I don't want to say it's because we're like a business, but we do have a lot of assets. We've got land, we've got equipment, we've got buildings, all those things exist.

Mr. SAVAGE. And the proof of that is, as you said earlier, when you sell off some of this we reduce it——

Mr. SHAW. That's right, it's ridiculous. It's a ridiculous way to say that we're meeting our requirements by selling our Federal assets.

I yield back.

Mr. SAVAGE. Thank you.

Congressman Lewis?

Mr. LEWIS. Thank you very much, Mr. Chairman.

Mr. Wolf, your testimony has been quite helpful to me as a new member of this committee and as a new Member of Congress.

I was just wondering why we never used appreciation in budgeting. The land, the buildings, the real estate that we own—you used the example of a house——

Mr. WOLF. Well, if we were looking at financial reports and financial statements, we would have those assets on there. And then the question of whether they have appreciated in value becomes relevant.

In terms of looking at budgeting, we're not trying to deal with past transactions. In financial reporting you try to report on all of your past transactions, acquisitions of assets and everything. In budgeting all you're looking at is going forward. What are we going to do this year? So appreciation of prior assets wouldn't really show up in the budget.

You're right, though, it is an important item. If you're trying to look at the $2.3 trillion debt and compare our assets to that, then you do want to look at what the current values of those assets are.

Mr. LEWIS. Thank you. Let me just ask one other question, Mr. Wolf. I would like for you to elaborate on your views on a Constitutional amendment requiring a balanced budget, giving the President authority to line-item veto. What are the views of the GAO on that?

Mr. WOLF. I'm going to have to put it in terms of my views because at this point we have not tried to take a position on it—that's not entirely true. I guess some of our older reports have taken some positions.

But the basic question that those two things bring up is a balance of power issue between the White House and Congress. Frankly, we'll leave that to Congress and the White House to work out.

They are different in that respect from capital budgeting. Capital budgeting is not a balance of power issue. The States that we talked about that have balanced budget laws have all sorts of different models. Some have a line item veto; some don't. Let me put on my hat as an individual for a second. I'm not sure that that's what we need to deal with our problem. I would be a little reluctant to see us hop into that without getting some of these other things straightened out first.

One of the things that concerns me, though, is that if we don't begin to look more realistically at what's in the budget, then we're

going to get calls for that kind of stuff and they're going to continue to increase. I don't necessarily think that would be a good idea, but I am not talking as GAO on that particular issue. We've sort of said, Congress and the President have got to work that one out.

Mr. LEWIS. Thank you.

Mr. SAVAGE. Congressman Clinger?

Mr. CLINGER. Thank you very much, Mr. Chairman.

Thank you, Mr. Wolf, for a very excellent statement. I agree with most of it, so I am delighted to commend you on the statement.

I think that in essence you are saying that at the present time and under the present system we are borrowing enormous amounts of money for both operating expenses and for capital expenditures, and we don't really know how much is being borrowed for each. Is that correct?

Mr. WOLF. Right.

Mr. CLINGER. In other words, the total capital financing requirement of $112 billion is really an estimate. You based it on pulling certain things out of the unified budget to establish that figure?

Mr. WOLF. Yes.

Mr. CLINGER. I guess what you're saying is that Gramm-Rudman ultimately is going to put almost impossible constraints on our ability to function because it is going to require driving the overall deficit for both capital and operating down to zero, and that's unrealistic in a modern age; whereas if we had a capital budget we could establish a Gramm-Rudman kind of stricture which would drive the operating deficit to zero but would recognize that the amounts we were borrowing for capital expenditures were justified because of the value which they provide to society. Is that basically it?

Mr. WOLF. That's true, although what we're saying is that capital budgeting itself is neutral on that issue but it permits either Congress or the President to make that kind of a decision. Right now, because that doesn't exist, we are all forced to try and get that $220 billion number down to zero because it's the only number we deal with.

Mr. CLINGER. Right. But there is certainly far less justification to be borrowing money to just operate the day-to-day activities of the Government than to invest in new bridges or new highways or whatever the capital expenditure might be.

On that issue, would you just go over what your definition of capital expenditure was again?

Mr. WOLF. Tangible? A life longer than either a year or two years, used in Government operations or to provide public services, owned by the Federal Government or clearly in the public domain as opposed to being owned by somebody else. This says, for example, that highways are in the public domain, whereas if you were to give money to somebody to build a university building which would then be owned by the university, we're saying no, that would not be in there. And it also excludes what I would call "consumable items." One of the bigger chunks is military; what we have said is major weapons platforms but not consumable supplies, ammunition, spares, warheads, all of those things.

Mr. SAVAGE. Would the gentleman yield?

I just want to add, if you will permit me, Mr. Wolf, that there is great difference among economists, isn't there, over the concept of restricting the definition to tangible items?

Mr. WOLF. Yes. As I said before, the definition in particular, really in two places, is what gets discussed and issues are raised—three places. Should you include military? Most people have tended to say that if you restrict it to major weapons platforms, yes. Should you include things that we don't technically own—the highway issue? I think most people feel comfortable, but I won't portray everybody as comfortable, with the fact that we should include the highways. And the third one—which is the third one? I'll think of it in a minute—and the issue which you raised, which is what a lot of people call "soft capital investments."

Mr. SAVAGE. In addition, there is a danger in simply equating a matter such as the platforms for the weaponry systems—there is a danger of simply equating that with capital items outside of Government operations. Say, for instance, you can fairly well find common agreement on a line of depreciation for a house or for a building or for an automobile or for a truck or what have you, but it's not so easy with regard to defense structures. The platform, for instance, could suddenly become obsolete. It's difficult because of the volatility of progress in the defense industry. It's difficult to really get agreement on that line of depreciation.

Mr. WOLF. Well, look at what—the President is going to sign an agreement that says we're going to tear up some investments we've made. You would have to deal with that.

The problem gets even tougher when you try to figure the future value of education, to use one of those "soft investment" types of things. That is, I think, why most people have ultimately said, okay, if we clearly identify up in the operating those investments that we're making in soft capital, maybe we can live with this.

Mr. SAVAGE. Congressman Clinger, you can see that I raised this question to make it clear that this matter is fully obfuscated. [Laughter.]

Mr. CLINGER. Well, I think this question of definition doesn't need to be solely an economic determination. I know that in 1984, for example, the definition of what was capital was a purely political decision and really had to do as much with the jurisdiction of this committee as anything else.

Mr. WOLF. Can I throw something in there?

Mr. CLINGER. Yes.

Mr. WOLF. One of the things we're struggling with is credibility—for example, in the financial markets and in the public area. All of the other models of financial analysis and reporting and that deal essentially with tangible assets as investment. If we try to put through a capital budgeting approach which goes beyond that which the general public and the markets are comfortable with as a concept of capital, then I think we're going to run into the problem of "smoke and mirrors" or whatever you want to call it. And that's another reason why we've tried to take a very restrictive view, although it does have some political implication. I can't argue with that. But it's ultimately going to be a political decision.

The risk in going too far is that the outside world says, yes, see, it's a political decision rather than something founded in——

Mr. CLINGER. Precisely. That's why I think it's important to have a fairly hard and fast definition of what we're talking about. One of the arguments that is always used against capital budgeting is that once you establish a capital budget, everyone is going to want to slide their program onto the capital side of the ledger because you justify the borrowing if you have it over there rather than the operating side. So you've got to guard against the obvious kind of incentive there would be to try to get something categorized as "capital."

Under your definition we're talking about this morning, what about the construction grants program under EPA, for example? There's a program which is largely financed by the Federal Government through a grant program that is ultimately going to end up being a loan program. But at the moment, it's a grant program. Title does not vest in the Federal Government as I understand it, and yet it's a major expenditure for infrastructure.

Mr. WOLF. Yes. As I recall, it's $2 billion to $3 billion. That's one of the ones that are right on the margin; in fact, in the definition I gave that would probably not be a capital investment because it is neither ours nor the public domain's. It's usually owned by a community—

Mr. CLINGER. Like a sewer authority or whatever.

Mr. WOLF. Right. And they are in fact generating revenues a lot of times off of that system, so I guess—again, ultimately we've got to have some rules that are pretty well defined, but I'd put that one over on the other side.

Mr. SHAW. Would the gentleman yield on that?

Mr. CLINGER. I'd be happy to.

Mr. SHAW. It generates revenue for the municipality. However, the Federal share is not related in the rate structure. Having been a mayor, I know how easy it is to find free money and not put it in the rate structure. So I don't know of any municipality that would.

However, I do firmly believe that as a condition for these grants, that the municipality or the receiving agency should be required to put it into the rate structure; then take that money, and if they don't pay it back to the Federal Government, at least be required to invest it into a fund where it will be available to take care of depreciation and obsolescence and replacement of the plant. In that case it would be a one-time expenditure of the Federal Government and we wouldn't have to be going back and redoing existing plants. That's been a hangup of mine for some time. Ever since I got out of city government into the Federal Government I've seen the wisdom of doing that. Thank you. [Laughter.]

Mr. CLINGER. I just have one final question, Mr. Chairman.

One of the arguments that Office of Management and Budget has used in the past to oppose moving toward capital budgeting is that under the present system they feel that flexibility to move things around is absolutely necessary within the overall unified budget as conditions and circumstances may warrant, and that by adopting a capital budget we are going to build fences around those things called "capital" which takes away what they say is essential flexibility and the ability to conduct the fiscal affairs of the Government. Do you see merit to that argument? And if not, why not?

Mr. WOLF. First of all, if you look at most of the appropriations bills there are a lot of fences built in them already, especially on capital budgets. So I don't think the ability to shift money really exists quite as much as is supposed. And I think that you could put whatever flexibility you want into this kind of thing in the appropriations bills afterward. You can set your targets, you can do all of these things, you can make changes later on. I don't think that's a big problem.

Mr. CLINGER. In addition to having merit—making more sense from a budgetary point of view—doesn't a capital budget also give us a better planning tool?

Mr. WOLF. Yes. I think so. It gives some better focus to those long-term investments.

Mr. CLINGER. All right. Thank you.

Mr. SAVAGE. Congressman Ballenger?

Mr. BALLENGER. Thank you, Mr. Chairman.

Mr. Wolf, this subject is rather fascinating—I happened to have served on the appropriations committee in a balanced budget State. In 1974 we had a rather substantial recession, and the way North Carolina balanced its budget was with a capital budget. I wonder if you're opening a can of worms.

If you could take the operating deficit of $158 billion and stop all capital investments—I mean, in North Carolina's case we didn't build any university buildings, we stopped everything. I realize the Federal government is likely to have an aircraft carrier half built or loan disbursements which would make it impossible to halt capital expenditures, but if you could—am I wrong in saying that if you stopped your capital investment of $149 billion and used your capital revenues of $36 billion, you could actually balance the budget with a capital budget? If you deduct the $149 billion unspent from $158 billion, that leaves you $9 billion over, and then you have $36 billion——

Mr. WOLF. It doesn't work.

Mr. BALLENGER. It doesn't work?

Mr. WOLF. Because the $149 billion is not deducted to get to the $150 billion. So if you stopped your capital programs, all the things that are up above that $158 billion would still be going on.

Mr. BALLENGER. But you would not spend the $149 billion.

Mr. WOLF. That's right.

Mr. BALLENGER. So you could use that against the $158 billion?

Mr. WOLF. No. No. You wouldn't have to borrow that $149 billion, so instead of borrowing $220 billion you would probably end up borrowing something—if you stopped all $149 billion and did nothing else, then you would still incur an operating deficit, but you would probably only borrow — well, $220 billion minus $170 billion. You would borrow $70 billion.

Mr. BALLENGER. And you have $36 billion in additional capital revenues in your capital budget.

Mr. WOLF. Excuse me. Yes. I guess you'd have to — let me think. You'd have a loss of $158 billion; that would be $108 billion, and you've got $36 billion—you'd have about $70 billion in borrowing this year.

Mr. BALLENGER. Right. This discussion is all theoretical; I realize that.

Mr. WOLF. But if you go back to the house analogy, my $10,000 profit, let's assume it's a $10,000 profit. I'm spending more than my salary, so I've got a $10,000 loss. I'm also going to buy a house for $40,000 this year. Well, not buying a house, I'm still losing $10,000; but if I don't buy the house, I'm at least not borrowing $50,000. I'm only borrowing $10,000.

Those are all decisions that Congress and the President can make using this information. None of those are decisions that either of those two parties must make.

Mr. WOLF. Could I just make two brief comments?

Mr. SAVAGE. Go right ahead.

Mr. WOLF. One of them is that one of the questions that invariably gets asked about capital budgeting is, isn't it going to open up the spending for capital items? Aren't we going to just open up the floodgates, sort of? That has not been the experience at the State levels at all. They have realized that no matter which way you budget, you can't just go spend willy-nilly. You've still got to finance your borrowings and you've got to control what you're doing. That is not a particular problem; at least, it has not been. That's not to say that we won't have problems with it, but the experience has been that that's not.

The other is that people raise the issue of "smoke and mirrors" with this. We do not think that this is "smoke and mirrors." People say, well, by having capital you can fudge and play games and one thing and another. I think we're kidding ourselves if we think that the current system prevents that kind of stuff; it doesn't. And going to capital budgeting isn't all of a sudden going to take us from no games to lots of them.

I'll stop at that. Thank you very much.

Mr. SAVAGE. Are there any other questions?

Mr. SHAW. Mr. Chairman, I'd just like to add my thank you to the witnesses this morning; to you, Mr. Wolf, for a very good statement. You've brought a lot of things down to earth where they ought to be.

Just to add further, the total financing requirement figure still comes out of the available capital—we're not only talking about the country now, we're talking about the world. So regardless of what the accounting system is, we still have to be very sensitive to that figure. But I think that capital budgeting certainly would give us a much more accurate picture of what we're doing, and capital budgeting is much less subject to manipulation than the cash accounting system that we have now, which I think is a prime example of "smoke and mirrors" when you can sell assets to balance your budget.

Thank you.

Mr. SAVAGE. Any other comments or questions?

[No response.]

Mr. SAVAGE. Again, let me thank you, Mr. Wolf, and your associate, Mr. Kirkman. This hearing is adjourned until 10:00 a.m. tomorrow morning in this same room.

[Whereupon, at 12:03 p.m., the subcommittee adjourned, to reconvene at 10:00 a.m. on Wednesday, December 9, 1987.].

[Mr. Wolf's prepared statement follows:]

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Capital Budgeting for the Federal Government

Statement of
Frederick D. Wolf, Director
Accounting and Financial Management Division

Before the
Subcommittee on Economic Development
Committee on Public Works and Transportation
House of Representatives

GAO/T-AFMD-88-3

Mr. Chairman and Members of the Subcommittee:

I am pleased to have this opportunity to discuss with you our views on the concept of capital budgeting and its usefulness in making federal budgetary decisions. Later in my statement, I will explain GAO's capital budgeting proposal, and why I think it is a good idea for the federal government. Before doing that, however, I would like to focus for a moment on our nation's most pressing budgetary problem--the federal deficit, and how budget reform relates to it.

THE FEDERAL DEFICIT AND BUDGET REFORM

The number one problem facing the nation today is how to reduce the federal deficit. We as a nation are faced with making a fundamental policy decision--how much are we going to spend on government programs and services and how are we going to pay for them? The federal government needs to realize that it can no longer act as though it has virtually unlimited financial resources. This will require difficult budget decisions.

The recent Congressional/White House negotiations illustrate the difficulty of making those revenue and spending decisions. Although some agreements were reached in cutting the deficit, which was an accomplishment, I think that the public and the financial markets will be carefully reviewing those budget

decisions to ensure that they result in concrete rather than superficial improvements. Also, they are expecting more than short-term actions on reducing the deficit. They are looking for discipline and accountability in how we manage the government's financial resources. Therefore, in order to restore public confidence, we need to develop concrete steps for improving the way we budget.

Furthermore, let me express a word of caution. I am concerned that any reluctance to face the deficit problem and improve our budget practices will lead to a proliferation of constitutional proposals that, it adopted, would interject major new uncertainties into institutional relationships at the federal level. This could include a constitutional amendment limiting spending growth and requiring a balanced budget, or giving the President line-item veto authority or enhanced rescission powers. I am sure the Congress will want to study these various proposals carefully to weigh the institutional, economic, and budgetary implications.

There are, however, steps we can take that do not raise such balance-of-power questions, such as improving the budget's structure and numbers and streamlining the congressional budget process. These should not be seen as "solutions" to our budget deficit problem, but rather as steps that can help our lawmakers

in making decisions and taking actions on the budget and the deficit.

Mr. Chairman, let me now discuss one major proposal for improving the budget's structure--capital budgeting.

COMPREHENSIVE FRAMEWORK FOR PLANNING, PROGRAMMING, AND BUDGETING FOR CAPITAL INVESTMENTS DOES NOT EXIST

Based upon the work we have done during the past 3 years beginning with our February 1985 report, Managing the Cost of Government, we believe it is time to rethink the budget's structure. Since fiscal year 1969, the federal government has used a unified, cash-based budget. It was created so that the President and the Congress could address the cash flow--checks received and issued--of the government as a whole as well as in its parts. This budget structure generally has served the government and public well in terms of providing a comprehensive report of the cash receipts and outlays of the government. However, it has made no systematic distinction between outlays for capital investments and those for current operations. We believe such a distinction is important in order to provide a better and clearer understanding of the government's financial position and the true costs and benefits of its programs. This will lead to more informed budgetary decisions.

Before I go any further Mr. Chairman, let me briefly highlight the magnitude of our federal capital investments. Office of Management and Budget (OMB) data show that, in fiscal year 1986, federal outlays for physical investments ranged from $84 billion for acquiring federally-owned assets, to $107 billion if one also includes grants to state and local entities in support of their capital projects. In addition, federal direct loan disbursements amounted to $42 billion. In total, these capital investments represented about 13.2 percent of total federal outlays in fiscal year 1986.

Under the current unified budget, a dollar spent is a dollar spent. The current budget treats outlays for capital and operating activities the same, even though they are different in a key respect--capital outlays do not reduce the resource base of the government the way current outlays do because they represent asset exchanges. When an outlay is made to acquire an asset, whether it is a building or a loan note, it produces a future stream of benefits to the government. Under present budget scorekeeping rules, however, a $100 million expenditure to build a hydroelectric plant, for example, contributes to the deficit the same as a $100 million expenditure for current military fuel costs, even though the investment in the power plant will produce benefits to the government and public for years to come.

A capital budget component within the unified budget would resolve these deficiencies, but more importantly, it would also provide many benefits. Mr. Chairman, let me now discuss in detail several of the key benefits of capital budgeting.

BENEFITS OF CAPITAL BUDGETING

Provide More Deficit Control Options

Because the unified budget does not distinguish between the receipts and outlays for capital investments and those for current operations, it does not identify by operating and capital component the resulting deficit and borrowing requirements. For example, in fiscal year 1986, the government incurred a deficit of about $221 billion. The budget does not identify what portion of that amount was applicable to capital investments and what portion was applicable to current operations.

By not distinguishing between the receipts and outlays for capital investments and current operations, federal deficit control actions have no choice but to focus solely upon aggregate deficit totals. For example, Gramm-Rudman-Hollings deficit targets apply equally to capital and operating programs, which may unnecessarily restrict the debt control options available to federal lawmakers. In this regard, the federal government is clearly out of sync with state governments and, for that matter, the private sector.

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At the state level, 37 states have a distinct capital budget whereby the capital and current operations amounts are reported separately either within an overall budget or as separate budgets. Most of these states distinguish between capital and current operations for targeting balanced budget requirements. More importantly, 34 of our states require their governments to execute balanced budgets; all but a handful limit that requirement to the current operations part. Debt financing is permitted for their capital projects, subject to separate state debt limitations. At the federal level, however, the lack of distinction between capital investments and current operations closes off this option for targeting deficit reduction actions. It also makes it difficult to compare federal budgets and deficits with those at the state level.

In short, a capital budget would provide the President and the Congress an additional basis for targeting areas for deficit reductions in times of deficit spending. For example, Gramm-Rudman-Hollings deficit targets could be established for the capital and/or operating components of the budget as well as for the total budget.

Eliminate Disincentives
Toward Capital Investment

A capital budget would also help eliminate budget process disincentives toward physical capital investment. Under the

current unified budget, physical capital expenditures in a given year are reflected as if they were costs incurred in that year. For example, during the construction of a federal building, this scorekeeping practice "front-end loads" the costs shown in the budget for the acquisition, since the project will have sizable start-up cash payments. Such a project would be at a disadvantage during budget deliberations when competing with an alternative means of acquiring the use of a building that would have lower front-end costs, such as leasing, which has significantly higher long-term costs. This could result in decisionmakers selecting the leasing option even though it will entail larger, long-term costs. More importantly, it could result in disapproval of the project because of its initial effect on the budget even though the long-range benefits would be large. In a sense, it requires a capital asset to have a one-year payback to be able to compete equally with current operating costs, a clear manifestation of our focus on short-range thinking.

The disincentives toward physical capital expenditures also make it difficult to invest in productivity enhancing capital assets, at least for on-budget agencies. In the past, this has been a factor in taking certain programs off-budget. For example, the debate several years ago on revitalizing the U.S. Postal Service addressed the need for the Postal Service to make large capital investments. It was recognized then that as an

on-budget agency the Postal Service would be hard pressed to obtain the necessary funding, because of the budget scorekeeping practices that reflected a year's capital expenditures as if they were costs for that year.

A capital budget approach would deal with this budget bias by using a different scorekeeping approach. Capital expenditures would be distributed in budget reporting over the useful life of the capital investment. The amount reflecting each year's cost would be reported in the current operations part of the budget. Because of their long-term benefit stream, it is appropriate to annualize the costs of capital investments--known as depreciation--over the fiscal periods receiving the benefits. This would put capital investment amounts on a comparable basis with current operation amounts and eliminate the current budget bias against capital projects. I should add that the budget would continue to report total payments made in a given year for physical capital, but this total would appear in the capital component of the budget as a financing requirement, not as a current year cost.

Would More Accurately Report the Costs of Federal Direct Loans

Similarly, a capital budget would more accurately report the costs of the federal government's direct loan programs, a subject of much debate this past year. Under the current unified budget,

federal direct loans are fully reported as cash outlays in the year they are made. No recognition is made of the fact that the government, in making these loans, receives a real financial asset (the note promising future repayments), and that at least a portion of the loan outlays will be repaid in the future. This omission overstates the cost of loan programs in their early years. An opposite effect develops in later years when loan repayments flow back to the programs. The repayments are netted against new outlays and result in understating the costs.

Our proposed capital budgeting approach would overcome these distortions by reporting in the current operations portion of the budget the annual net cost of the loan programs and reflecting loan outlays and receipts in the capital or financing portion of the budget. This would put loan program costs on a more comparable basis with grant program costs.

This treatment of loan programs would provide another potential benefit--it could reduce the incentive to undertake loan asset sales and other asset sales mainly to reduce the short-term deficit, something many people liken to selling your garage to reduce your home mortgage. A capital budgeting approach with an emphasis on controlling current operating costs and deficits would eliminate this particular incentive for loan asset sales because, under the rules of capital budgeting,

proceeds from asset sales would not count as current operating revenues.

Start Providing a Link to Financial Statements

A capital budget would start providing a link to agency-level and governmentwide financial statements, something we believe is essential to increasing both accountability and discipline in our financial management system. Such statements disclose the cumulative effect of decisions on the government's financial resources and provide early warning signals to policy formulators and the public.

A capital budget would provide a useful complement to the financial statements. The two taken together would provide enhanced information on the government's assets, liabilities, and operations. The financial statements would provide a snapshot of the cumulative results of past capital acquisitions adjusted for depreciation, while the capital budget would show the planned activities.

Mr. Chairman, although a capital budget would start providing a link to agency-level and governmentwide financial statements, I want to point out that our current financial management systems cannot provide the financial information and accountability needed by the Congress, federal managers, and the

public. Important legislation addressing these problems, such as the Financial Integrity Act and the Debt Collection Act, has been enacted, but further improvements are necessary. I believe such improvements, if they are to be effective and lasting, must be guided by a cohesive framework under centralized leadership that is responsible for developing and implementing a governmentwide plan for improving financial management systems. Agencywide and governmentwide financial statements and the performance of annual financial audits will provide accountability and discipline. A copy of recent correspondence to the Chairmen of the House Committee on Government Operations and the Senate Committee on Governmental Affairs on this issue is included in attachment V.

Focus Attention on Nation's Physical Infrastructure

A capital budget would also help focus public attention on the nation's physical infrastructure needs. Federal, state, and local governments have invested hundreds of billions of dollars in physical capital investments--highways, bridges, water and sewer systems, airports, buildings, and the like. With the increased pressure on the federal budget and the ongoing debate about the federal government's relationship with other public sectors and the private sector, the way in which the federal government, states, and localities plan, budget, and protect the public capital investments needed for the future takes on added significance.

Mr. Chairman, I would now like to discuss the structure of GAO's capital budgeting proposal.

GAO'S CAPITAL BUDGETING PROPOSAL

Maintain Unified Budget But Report Separately on Capital and Operating Amounts

The federal government currently uses a unified budget that reflects the full scope and impact of government activities. GAO's proposal for restructuring the budget would result in the continued reporting of receipt and outlay totals for the federal government as a whole. Our unified restructured budget would, however, identify the operating and capital components for the unified budget total and for each of its functions, agencies, and programs. It would, therefore, maintain the unified budget's comprehensive coverage. Also, it would include account listings and schedules that report total program costs where programs involve both capital and non-capital items. By no means would we want to go back to the days of object class budgeting, when it was hard to ascertain total program costs.

As I indicated earlier, a budget restructured along these lines would permit budget balancing targets to be more focused upon current operations, if the Congress and President so desired. I should add, however, that with such a focus it would still be necessary to monitor and control the total borrowing

requirements of the government, including borrowing for capital projects. Federal borrowing for capital projects would be no different than other federal borrowing in their impact upon the aggregate economy, credit markets, and interest rates.

I would now like to refer you, Mr. Chairman, to attachment I of my statement, which illustrates in a very abbreviated form the current unified budget. It reflects the $220.7 billion deficit for fiscal year 1986. My remaining attachments are also for fiscal year 1986. I should note, however, that because of our innovative approach and the quality of existing data on capital expenditures and depreciation, we had to make several assumptions. Therefore, I would emphasize that the numbers are approximations for illustrative purposes only.

Attachment II illustrates our unified restructured budget. It would contain both an operating budget and a capital budget within the unified budget. Within each of these budgets, revenues and expenditures would be reported. The unified budget would combine the operating budget surplus/deficit and the capital budget financing requirements into a single unified budget total. One final adjustment would be made in order to report the total unified budget deficit on a cash basis as it is now. An adjustment would be made for the annual depreciation costs on government-owned assets. This would allow the unified budget deficit--referred to in the attached illustrations as

"total financing requirements"--to be consistent with current budgeting procedures.

Mr. Chairman, let me now discuss in further detail what would be included in the separate operating and capital components of the unified restructured budget.

Operating Budget Component

As you can see in attachment III, the operating component of the unified budget would consist of all cash revenues and expenses for those programs and activities that are not classified as capital investments. It would also include interest on the national debt and the annual capital consumption charge--or depreciation--on physical assets owned by the federal government. (The budget deficit is currently presented on a cash basis only and, as such, does not include depreciation.) For credit programs, it would include only the annual net cost of credit activities for each year. Thus, the operating component of the unified budget would reflect the annual net cost of running the government. An operating surplus/deficit would be reported based on these revenues and expenses.

Capital Budget Component

The capital component of the unified budget, as illustrated in attachment IV, would report both capital revenues and expenses. Capital revenues would include user fees, gasoline excise taxes, and similar amounts which are directly related, either by law or activity, to capital investments. It would also include revenues from the sale of capital assets. Capital investments would include the cost of capital programs which lead to the acquisition of physical assets or direct loan disbursements. It is important to note that the amount by which capital expenses exceed capital revenues would be reported as "capital financing requirements." The term capital financing requirement is used instead of capital deficit to reflect the fact that the government is financing a capital asset which has value and will produce a future stream of benefits, rather than incurring a cost.

Defining Capital Assets

There has been a great deal of discussion and debate, Mr. Chairman, over how to define the items that will be included in the capital component of the budget. We believe that it is necessary to have a narrow and disciplined view of what would be classified as capital. Under our proposal, we would define

capital assets as being of two types--physical assets and financial assets.

Physical assets would be assets with form and substance, that is, tangible, whose ownership resides or will reside in the public domain, and which typically provide services or benefits, including for national defense and security, for more than one year. Such assets would include, but would not be limited to, roadways and bridges; airports and airway facilities; mass transportation systems; waste water treatment and related facilities; water resource projects; medical facilities; resource recovery facilities; public buildings; space and communication facilities; railroads; defense facilities; major weapons platforms; and strategic petroleum reserves and mineral stockpiles.

Financial assets, as we define them, would include any legal instrument such as stocks, bonds, notes, and other securities held by the federal government.

I have to acknowledge, however, that the above definition is still too general. We need to establish good definitional standards in order to distinguish between capital investments and operating expenses. GAO is currently conducting a major study in this area.

It is not only crucial to establish good definitional standards, but also to monitor, through an independent audit, how those standards are applied. This would minimize the chances of officials misclassifying operating amounts as capital amounts, a gimmick that was used in New York City in the mid-1970's and earlier.

The Impact on the Executive Branch and Congressional Budget Process

Concerns have been raised, Mr. Chairman, regarding the impact capital budgeting would have on the executive branch and congressional budget process. The concerns are that capital budgeting would increase the complexity and workload of the process. Many of these concerns stem from the perception that a capital budget is completely separate from the operating budget. However, if capital budgeting is implemented in the form we propose--and within the unified budget--then this perception is avoided. Indeed, the new budget structure might help simplify budget debate and actions by providing a more meaningful breakdown of the budget's totals.

Within the executive branch, our proposal would require changes in how information is presented in the President's budget. Information currently provided by agency, appropriation account, and budget function would continue to be reported. However, there would be a clear identification of the

appropriation accounts, or parts of accounts, that are for capital purposes, and there would be new summary tables showing the capital and operating breakdowns within each agency and budget function. There would be no other changes in how the President's budget is prepared, reviewed, and approved.

On the congressional side, the main effect would be on the budget resolutions and related actions. Current functional categories--defense, housing, etc.--would be broken down into capital and non-capital sections, and the resolutions' aggregate totals would have capital and non-capital components. This also could and should carry through to affect the way budget deficit targets are set in legislation such as the Gramm-Rudman-Hollings legislation.

SUMMARY

We believe that capital budgeting within the context of the unified budget would be a major step in instilling better accountability and discipline and in improving our budget decisionmaking and control processes. It should be implemented as a key reform of our budget process and our financial reporting systems.

This concludes my prepared statement, Mr. Chairman. I would be glad to answer any questions.

ATTACHMENT I

ATTACHMENT I

CURRENT UNIFIED BUDGET OF THE U.S. GOVERNMENT
(dollars in billions)

	1986
Total revenues	$ 910.0
Total expenditures	1130.7
Surplus/deficit(-)	$-220.7

ATTACHMENT II

ATTACHMENT II

UNIFIED RESTRUCTURED BUDGET OF THE U.S. GOVERNMENT
(dollars in billions)

	1986
Operating budget	
Operating revenues	$ 873.2
Operating expenses	981.7
Capital consumption charge (depreciation)	50.0
Operating surplus/deficit(-)	-158.5
Capital budget	
Capital revenues	$ 36.8
Capital investments	149.0
Capital financing requirements	-112.2
Items not affecting funds	
Depreciation	50.0
Total financing requirements	$-220.7

ATTACHMENT III

ATTACHMENT III

OPERATING COMPONENT OF RESTRUCTURED BUDGET
(dollars in billions)

	1986
Operating budget	
Operating revenues	
General taxes	$ 464.1
Earmarked taxes	288.7
Market earnings	120.4
Total operating revenues	873.2
Operating expenses	
Defense functions	$ 210.8
Civil functions	634.9
Interest on debt	136.0
Capital consumption charge (depreciation)	50.0
Total operating expenses	1031.7
Operating surplus/deficit(-)	$-158.5

ATTACHMENT IV

ATTACHMENT IV

CAPITAL COMPONENT OF RESTRUCTURED BUDGET
(dollars in billions)

	1986
Capital budget	
Capital revenues	
Loan Receipts	$ 20.5
Direct capital taxes	16.3
Capital asset sales	--
Total capital revenues	36.8
Capital investments	
Loan disbursements	$ 42.2
Capital additions	106.8
Total capital investments	149.0
Capital financing requirements	$-112.2

ATTACHMENT V ATTACHMENT V

Comptroller General
of the United States

Washington, D.C. 20548

June 25, 1987

The Honorable Jack Brooks
Chairman, Committee on Government
Operations
House of Representatives

Dear Mr. Chairman:

The federal government's lack of effective financial management and accountability is being increasingly highlighted through our own reports as well as those made by agency heads under the Federal Managers' Financial Integrity Act and by the inspectors general. Recent reports are replete with examples of problems ranging from an inability to account for a half billion dollars of foreign military sales deposits to an inability to manage or report on the loans and accounts owed to our government. Billions of dollars are being spent on uncoordinated efforts to upgrade accounting systems which have routinely failed to meet their objectives. I am concerned about our government's inability to effectively hold federal managers accountable for their financial activities, generally because we lack essential financial data.

I am also concerned about our continued reliance on antiquated systems that do not provide the information required for effective management, program, funding, and revenue-generating decisionmaking. We can no longer afford to rely on systems and concepts that do not provide the financial information and accountability needed by the Congress, federal managers, and the public.

I know that you share my concern over the government's lack of effective financial management and accountability as evidenced by your strong leadership in sponsoring important legislation addressing these problems, including the Financial Integrity Act, the Single Audit Act, the Inspector General Act, the Prompt Pay Act, and the Debt Collection Act. Your leadership is needed once again.

ATTACHMENT V

We must build on these past legislative initiatives to continue improving federal financial management. I believe that improvement, if it is to be effective and lasting, must be guided by a cohesive framework under centralized leadership and must provide accountability and discipline. Agencywide and, ultimately, governmentwide financial statements and the performance of annual financial audits will provide this accountability and discipline. The financial management leadership must be capable of developing an overall plan of action which clearly defines objectives, and, equally important, this leadership must be capable of implementing that plan.

System improvement will not come about overnight. It is therefore crucial that the reform initiative be started promptly and have the assurance of continuity of its leadership, purpose, and approach across successive administrations. To achieve this, a financial management leadership structure must be legislatively mandated rather than left to ad hoc groups or initiatives.

Experience has shown that major federal management reform of any kind is more likely to succeed if it has a legislative underpinning. Consequently, we drafted the attached bill to address the long-standing financial management problems.

Very briefly, the bill provides for

(1) centralized leadership that is responsible for developing and implementing a governmentwide plan for improving financial management systems and reporting annually on the plan's progress,

(2) corresponding financial management leadership in executive branch departments and agencies, and

(3) annual preparation and audit of agency and governmentwide financial statements to foster accountability and system integrity.

I believe this legislation will enable us to more effectively manage and control the federal government's financial activities, will begin to restore the accountability and credibility of our government to the public, and will result in measurable monetary savings to the government of billions of dollars.

I am sending you our draft bill for your consideration because of your long-standing leadership in this area. I am also sending a copy of our draft bill today to the Chairman, Senate Committee on Governmental Affairs. I

would be pleased to work with you concerning this bill and would appreciate the opportunity to meet with you in the near future to discuss these important issues.

Sincerely yours,

Charles A. Bowsher

Charles A. Bowsher
Comptroller General
of the United States

Enclosures - 2

Note: This letter was also sent to the Chairman, Senate Governmental Affairs Committee.

CAPITAL BUDGETING

WEDNESDAY, DECEMBER 9, 1987

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON ECONOMIC DEVELOPMENT,
COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION,
Washington, DC.

The subcommittee met, pursuant to recess, at 10:20 a.m., in room 2167, Rayburn House Office Building, Hon. Gus Savage (chairman of the subcommittee) presiding.

Mr. SAVAGE. The second day of hearings of this Subcommittee on Economic Development will come to order for the purpose of receiving testimony to explain the advantages and disadvantages of establishing a Federal capital budget and its impact on the budget process and the legislation authorized by our full committee.

We are particularly honored today to have as our first witness the Honorable Daniel J. Evans, a U.S. Senator from the State of Washington, a former Governor of that State.

Before you begin, Senator Evans, let me just say that while we may be of different parties, I think you probably know that all Members of Congress are sorry to hear that you are considering not running for reelection. Your contributions have been in the interest of our Nation in a very non-partisan way.

Let me add this—in five minutes, Senator, I'm going to have to leave to go upstairs to testify before the Public Buildings and Grounds Subcommittee about a building we are trying to get renamed in honor of the late Mayor of Chicago, whom you knew, Harold Washington. I will not be long and I will be back. So, maybe I should announce now, because I will have to leave while you are testifying; and, to show you how non-partisan this subcommittee is and the trust we have in a member of your party who is a Member of this subcommittee, Bill Clinger will be intrusted with this gavel as long as the Democratic Staff Director, Carl Lorenz, sits at his side.

Senator Evans?

TESTIMONY OF HON. DANIEL J. EVANS, U.S. SENATOR, FROM THE STATE OF WASHINGTON; AND HON. JOSEPH J. DioGUARDI, A REPRESENTATIVE IN CONGRESS FROM NEW YORK

Senator EVANS. Thank you very much, Mr. Chairman. I appreciate those words and I will not emulate Abraham Lincoln who was able to give the Gettysburg Address in slightly more than three minutes; I can't possibly do that. But, hopefully and in a relatively few minutes, I can speak on the real importance of capital budgeting.

I would ask that my full statement be placed in the record and I will summarize it for you.

Mr. SAVAGE. Without objection, so ordered.

Senator EVANS. The room is not filled with spectators and that's to be expected. This is not a politically sexy kind of issue and yet it probably is as important—maybe more important—than many of those issues which are politically exciting. We could, if we'd put our fiscal house in order, our bookkeeping house in order, present a clearer and a more honest picture to the citizens of this country; we could give better guidance to those of us in Congress who have to deal with budgeting. I think we might even give a little guidance to the Office of Management and Budget—which would be highly desired—in a more straightforward and understandable view of our budget and its processes.

I might say, in passing, that there are many in this Congress who avidly support a balanced budget amendment to the Constitution. And yet in doing so, few of them even understand, in reality, what a balanced budget is or ought to be under proper business accounting, and accounting which can be translated quite effectively, I think, to Federal Government.

With that, let me first say that I do appreciate very much the assistance of Charles Bowsher, the Comptroller General, and his staff. They have been remarkably helpful in developing some of the concepts that are placed in this bill. Through the Federal Capital Budgeting Act we seek to identify, define and present separate operating and capital components of the Federal budget while maintaining a unified budget. Our goal is to provide what the existing budget does not—that is, adequate and clear information on revenues, expenditures, surplus and deficit amounts, and financing requirements for capital activities of the Federal Government.

In the bill we also seek to distinguish between capital and operating activities in a manner which does not hinder identifying the resources needed to meet the Government's capital infrastructure needs. And I should highlight that—that this legislation does retain a unified budget concept; it does not attempt to reduce the Federal budget deficit by taking capital expenditures off budget. I think that would be irresponsible. It remains in the unified budget but it helps us better define what really is a balanced budget under the terms we understand as individual citizens, an overwhelming percentage of State and local governments, and virtually every company and corporation in this country. It's only the Federal Government—as an institution of any size at all—that ignores the fundamental concepts of a capital budget.

The private sector and a large majority of State and local governments have set a financial example which the Federal Government would do well to emulate. The benefits:

First, that it focuses attention to a greater degree on the deteriorating physical infrastructure of the Nation and allows us to make more rational investment decisions.

It promotes intergenerational equity—and I think this is important—by burdening future generations with debt service only for activities that provide future tangible capital benefits.

Third, it provides more equitable budget treatment of capital activities by avoiding the current front-end loading of the full costs by expensing them in the first year.

Fourth, it shows that borrowing to finance capital investment is accompanied by an increase in the Nation's assets. And, that's something we don't see at all in terms of today's budget.

In addition, State and local governments will find that a separate capital budget creates a clearer picture of capital needs and the related financing requirements by highlighting the connection between a capital project and financing requirements. State and local governments can better cope with the more restrictive options for raising revenues and meet the balanced budget obligations which many of them face—virtually all of them face.

As Governor, we attempted to create budget and accounting processes that could be easily understood by the taxpayers of Washington State. This effort culminated in an interesting report to the people of the State of Washington in the form of, essentially, an annual report, or at least the equivalent of a stockholders report.

We recalculated the budget of that time; that was before we had adopted GAAP accounting principles. We took the one year of the budget—the very same figures that we had which showed a balanced budget—we recalculated them in full GAAP accounting and took into account the full capital assets that were being created and the depreciation that went along with it. We found that while under Governmental accounting we were at virtually a tie—a balanced budget with no excess; and, under the other accounting we showed a surplus of almost $200 million for that year.

We also created an asset and liability calculation and, for the State of Washington, at least, with very large landholdings and other assets, we found there was a considerable asset for each individual citizen in the activities of Government, which came as a surprise and shock, I think, to many, and which was widely reported in the editorial pages of the newspapers, I think to their astonishment as well as the people's astonishment.

So, there is some value in more clearly and accurately pointing out to people just where they stand in terms of their own Government.

But while capital budgeting is a help, it's not enough. We've got to do some other things, Mr. Chairman, and first among them, I think, is to consolidate our accounting systems.

Currently, the Federal Government uses 154 separate accounting systems. Each one is tailored to the needs of the particular agency using the system. There is little coordination of financial information. And, fortunately, GAO is working—and working hard on this problem—and has already developed programs which can help bring greater rationalities to the Federal accounting process.

I think, Mr. Chairman, what we really need to do is change our financial mindset, both in the Executive and the Legislative Branch. We can do that, I think, by emulating, to the degree that it is appropriate, the fundamental practices of the private sector—maintaining books of sufficient coherence so that stockholders—or citizens—are not mislead and they can be sure what management is up to. I think Congress should consider itself, more than we have

in the past, as the board of directors of this Government and, with this responsibility, must ensure that the people—or the stockholders—understand just what it is we are doing.

Let me end, Mr. Chairman, with an interesting example.

I have been in contact with Michael Boskin, a professor at Stanford University, who I understand will be testifying before this committee in a future hearing. He has done some fascinating work on the Federal budget and how it operates. In my conversation with him, he talked about just completing a recalculation of the Federal budget as if it were a private corporation, with some very different results, of course, than the results we find. I told him that it might be interesting for him to do the opposite—take some corporations and do their books in Federal accounting and see how he came out. He said, "That's a whale of an idea"; and, he did that with some very interesting end results. Let me just point them out to you.

He did a number of corporations and here are some of the results:

General Motors, 1984, reported under GAAP accounting and under their books a profit of $14.22 per share. Under what Mr. Boskin calls the generally unacceptable Federal Government accounting procedures—which he terms GUFGAP instead of GAAP—General Motors would have shown a loss of $4.82 a share that same year.

Somebody is misleading somebody, and I have a suspicion I know who it is—it's the Federal accounting system that misleads.

IBM, in 1984, showed earnings of $10.77 a share; under Government accounting, a little over $3 a share. And, it goes on. Seattle First National Bank, which had some very serious problems on some oil loans they made a few years ago, showed a substantial loss that year; but under Government accounting, they would have shown a profit of almost $2 a share—misleading the stockholders and the depositors of that bank rather substantially.

So, Mr. Chairman, I think it's long overdue for us to take on what is an important task, but one that's not generally recognized as such by those who are more interested in those items that have political sex appeal. This may be a plain-Jane, but it's very important, I think, for the benefit of this Congress, this Administration or any Administration, and for the country.

Thank you, Mr. Chairman.

Mr. SAVAGE. Thank you very much, Senator Evans. May I start out by making sure I understood you. You accept the concept of a unified Federal budget?

Senator EVANS. Yes. And, I think that if we don't do that, we are just leaving out a lot of the expenditures. We just have got to make sure that when we have a unified budget that we are very careful to make sure that all of the elements within that unified budget are accounted for and accounted for accurately and under a standardized bookkeeping system.

Mr. SAVAGE. So, going into capital budgeting, it would be mainly to serve as a tool so we can better understand where we are now in order to plan for the future, and so forth. Do I understand you?

Senator EVANS. Yes, very much so. I think that a capital budget would show several things. It would show us for the first time, for

instance, what a capital investment really does. Unlike some expenditures that are spent and go away, there are assets along with the expenditures. Now, I think it's important to be able to show those assets or recognize the assets that grow with a capital investment, just as we show the debt grows under a capital investment.

Mr. SAVAGE. That leads, then, to two questions. One is: would the political effect of that—that is, the effect on this body—be to ease the pressure to reduce our Federal deficit?

Senator EVANS. I don't believe so if it's shown accurately. What it would merely show is that each year, if you took this last year, for instance, what it would show is that the deficit would go up just as it had before, but a portion of that deficit would be capital borrowing and the rest of it would be the amount that we are in deficit for operating purposes. Frankly, I think that might more clearly show to all of us that we are borrowing in order to handle our operating expenses. And, by showing that separately, we could then focus on the fact that that's the portion of our annual deficit that we simply must eliminate.

But, I think that those who suggest that we need a balanced budget amendment to the Constitution under current accounting procedures are really not being fundamentally honest. That would be like saying to an individual, if you buy a new house in one year, you have to have sufficient income to pay for that entire house. Well, obviously, if that person borrows for that capital asset, they think that they have a balanced budget if they have sufficient money to handle the debt service for that year for that new capital investment. And I think that's the kind of thing we ought to recognize.

Mr. SAVAGE. Well, yesterday we had as a witness, Fred Wolf, Director of the Accounting and Financial Management Division of the General Accounting Office, GAO. He indicated with some charts and using the concept of borrowing to buy a home—which simplifies it and puts it in more familiar terms—that if we were into capital budgeting for the 1986 Fiscal Year, the deficit for that year that had been estimated, for our legislative purposes, as being something around $200 billion, would be reduced by roughly $50 billion; the reason being, of course, that you would offset some of the expenditures with the out-year value of the things purchased.

Do you follow?

Senator EVANS. Oh, yes, Mr. Chairman.

Mr. SAVAGE. Do you agree with that?

Senator EVANS. I think that there's some mixing up; I would have to look at his testimony to speak specifically to it; but, I think there is some mixing up of the difference between the profit and loss statement and an asset and liability calculation.

In terms of a profit and loss or an annual budget, the amount that you'd still show on the asset and liability side is that you had expanded the debt in the very same way that our current budget would show by the annual deficit, but a portion of that debt would be offset in a bookkeeping sense by a recognition that you're creating new assets, every time you build an interstate highway, for example.

Mr. SAVAGE. That's right.

Senator EVANS. But that doesn't change the amount of debt that's out there; it doesn't change by a dollar the deficit of that year, it just accounts for it in the two different places that I think ought to be recognized. What it does point out, for instance, I for one do not believe that it is necessarily appropriate for us to reach a so-called balanced budget under our current bookkeeping system. It would produce the same kind of abberations that I just mentioned in terms of corporate accounting. But, I do think we ought to, as rapidly as we can, close the gap between the expenses and the income for operations of the Federal Government, and recognize that probably it is appropriate to add to our debt slowly, each year, to the degree we are instituting capital investments which have some value.

Mr. SAVAGE. Which is precisely the point of my question. In banking, obviously, consideration is given, in terms of the financial stability of the customer, not only to the amount of debt, but also the amount of assets; just as you've indicated. And, I wonder whether the effect of that would be to ease pressure.

Say, for instance, if a person went into a bank to make a loan and his debt far exceeded his assets, then that would be pressure on him or the corporation to either reduce the debt or increase the assets in order to make the presentation more acceptable.

Would that not also have that same effect with regard to the present pressures on us for deficit reduction—that is, the argument would then arise that, well, the deficit really is not as great as it had appeared on a unified budget?

Senator EVANS. I don't really believe so. I think what's really important is that we sometimes focus on the number of dollars of debt that we have without trying to relate it to our capacity to handle that debt; whether we're individuals, or States, or National Government, it seems to be that maybe a more important focus is what percentage of our income goes into the servicing of our debt. And, if that percentage keeps going up, regardless of whether it is for capital outlay or for operations, we're headed for trouble.

And, so, I think that if we keep that kind of focus and understand the entire picture, I don't think that it would have the effect you suggest.

For instance, last year, interestingly enough and almost with no notice of the outside financial markets or anyone else, for the first time in more than a decade, the percentage of income that went to service our National debt went down rather than up. It went down because we had a sharp drop in the deficit added to the debt, and we had enough of an increase in income coming in so that the percentage of that income this last year that went into total debt service went down—admittedly, by only a small amount—but it's the first time in more than a decade that we've seen any good news on that account.

I don't think we need to get to the point any time soon—maybe never—where we end up with no debt and no debt service. We don't expect AT&T, or IBM, or any of the major corporations, or even ourselves as individuals who own homes that have substantial mortgages to get to that point; we'd like some day to get to that point, but we would probably get down to that point and then we'd buy a bigger home and get a newer mortgage. And, as long as we

can handle comfortably the cost of that debt, and as long as the debt is truly a debt for capital purposes, we're probably somewhere close to fiscal reality. When we start to add to debt through credit cards and handle our daily expenses, then, as individuals we are headed for trouble and, as a country, I think we are headed for trouble.

Mr. DIOGUARDI. Mr. Chairman.

Mr. SAVAGE. Yes.

Mr. DIOGUARDI. I know I'm going to be testifying next, but I know you're going to have to leave and I just wanted to make a comment that I think is germane to that, because you're making an assumption that, with respect to the Federal Government, that our assets may exceed our liabilities in any one year of expenditure or overall; and, in my testimony, I'm going to make the point that there will be many people who might agree with your statement before, Mr. Chairman, that a capital budget might further disguise economic reality unless we put the books of the Government on a true generally accepted accounting principles basis, because there are many liabilities right now that are unrecorded. So that, if you converted the books of this country to a proper set of accounts, you'll find that you will not get the result of the State of Washington. You'll find that there are so many unrecorded liabilities for contingencies, guarantees, accrued pensions for civil service, military and, perhaps, even social security and accounts payable that you will find that the situation is much worse even with a capital budget after you put the assets on the books.

And that's going to be the sum and substance of my testimony.

Senator EVANS. I would totally agree with the Congressman; I think that's exactly what we would show and that's important to show.

Mr. SAVAGE. Senator Evans and Representative DioGuardi, we are being joined by our Ranking Member, Clay Shaw of Florida. But, let me also add as I take my leave, and thank you again for your testimony, that though there will be questions now coming, I leave with the two-party system intact, because we've been joined by my good colleague from Ohio on the Democratic side, Douglas Applegate, who will take chair.

Mr. CLINGER. Mr. Chairman.

Mr. SAVAGE. Yes.

Mr. CLINGER. May I just make one comment.

Mr. SAVAGE. Certainly.

Mr. CLINGER. I just can't tell you how sorry I am to see that Mr. Applegate showed up this morning.

Mr. APPLEGATE. Mr. Clinger, I think, has some questions that he would like to ask.

Mr. CLINGER. Thank you, Mr. Chairman. I would just like to join in welcoming Senator Evans.

Senator, you honor us with your presence and I commend you for your leadership in this, as you say, not very sexy but important area of our work here. I am very privileged to have been working with you on this legislation and pleased to be able to report to you that your bill was introduced here in the House with cosponsors yesterday afternoon.

Senator EVANS. I'm delighted.

Mr. CLINGER. Hopefully we will begin to see some progress on the legislation.

I just have few comments and questions.

I think one of the things that you alluded to was, in rebutting an argument that is often made by OMB and others in opposition to capital budgeting, that somehow we are going to vastly increase the potential for more borrowing; that somehow we are going to raise expectations to the point where this is going to provide tremendous pressure for additional borrowing. And, I think you have correctly identified that, in fact, it will be just the reverse, because what we are doing is providing a means of identifying that which borrowing is legitimate—that is, for capital needs of the country; and that for which borrowing is illegitimate—that is, to operate the day-to-day affairs of the Federal Government. And, if nothing else, a capital budget will enable us to make that kind of distinction which we are presently incapable of determining.

We are clearly borrowing huge sums of money just to operate the day-to-day affairs of the Federal Government, which is clearly very irresponsible. So, it seems to me that if nothing else, the Federal capital budget brings to our affairs a sense of better control over that kind of emphasis.

As Governor in the State of Washington, you worked with a capital budget for some time and you were one of about, I think, 40 Governors or 40 States that utilize capital budgeting routinely. But, I'm wondering, in your experience, because of the Federal-State relationship and the fact that there are partnerships in so many programs, projects and activities of the Federal Government, did it cause you problems in being able to come up with a capital budget that made sense—the fact that the Federal Government did not have a capital budget and, therefore, was operating on a year-to-year basis? How was it possible for you to have any interface between what you were planning and projecting when you couldn't really determine what the Federal Government was planning or projecting because they had no capital budget?

Senator EVANS. Well, there's no question that it's more difficult. It was exacerbated by the fact that we had and still have, a biennial budget, while the Federal Government, of course, is operating on an annual budget with the different fiscal year—our's is a July 1 fiscal year and their's is an October 1 fiscal year, of course; and, all of those things complicate the relationship.

And, many—as you point out—of the capital projects we had at the State level are really partnership projects looking both ways. Many of our sewer and water and other kinds of facilities have some Federal participation, State participation, and local participation. So, there's a complexity in all of that which makes things difficult, not impossible.

It would sure be a lot easier if we not only had an understanding and an acquaintanceship with the Federal budget but with generally accepted accounting procedures at the Federal level which would then coincide with our State and with an overwhelming number of other States.

I guess the fundamental question is whether this does or doesn't add to the pension for borrowing. I don't think there's anything wrong with truth in packaging, and I think we ought to at least

honestly state where we are, and then it's up to us to have the discipline, and people to push us to have the discipline, to quit borrowing for operating purposes.

We did one other thing at the State level which I think is important. Ultimately, we did pass a Constitutional amendment which put a limit—it was a percentage of income limit—on the debt service which we could have at any one time.

That may even be a more important kind of Constitutional limitation—although, I'm frankly not a fan of Constitutional limitations—a more important one than the current drive toward a balanced budget.

I think the figure was nine percent, and it has since been reduced somewhat, but I believe the Constitutional amendment was nine percent of an identifiable revenue to the State. And, so, it's a flexible one; it keeps rising, but it forces some discipline on the legislature and the Governor and how much they can borrow even for capital purposes; and, it keeps it within some limit of their income.

Mr. CLINGER. It was pointed out yesterday by Mr. Wolf that under Gramm-Rudman, for example, we are expected to drive the deficit down to zero by 1991 and that, in view of the fact we make no distinction between capital expenditure and operation expenses, that that would be a disastrous requirement, because you're forcing us to say that we are not going to borrow, we are not going to commit any kind of resources on a long-term basis for necessary capital improvements in this country.

Senator EVANS. It could well have adverse economic effects.

Mr. CLINGER. I think it would.

One of the issues that we always talk about when capital budgeting is before us is what is capital and what is not. And, I guess, what is capital is always in the eye of beholder—whoever happens to be looking at it. But, clearly, there would be pressures brought to bear to try to have a program included as capital if you feel that you could borrow for those purposes. How do you address that in your bill?

Senator EVANS. Well, capital assets we do identify; and there are two types of capital assets—financial assets and physical assets. Physical assets, particularly, we have tried to eliminate the complexity and the difficulty of many, many really small elements by limiting any identified in the capital budget, be those assets which have an initial value of over $500,000. So, that, in itself, helps to really focus on what truly are capital assets.

We go through an extensive description trying to make sure that the description is clear enough to try to clear out all of that penchant for adding what truly are operating expenses and try to hide them into a capital budget.

And, I think that that's a place we ought to focus as these bills come before our committees and work is done on them—to make sure that we are clear in that aspect of things, and try to minimize, at least, the amount of things that ought not to be capitaled but do tend to sneak in.

Mr. CLINGER. But I think we can do that through the legislative process. It doesn't necessarily have to be an economist's view of what is capital or what is not capital, but a political view is equally legitimate.

My understanding is this bill requires the President to include with his annual budget submission capital components and operating components. Would not this be imposed upon the Congressional budget process?

Senator EVANS. No; this starts with the President's presentation of a budget to the Congress; it would have the capital components within a unified budget, so it would still be a unified budget, but it would show the capital components.

I agree with my colleague that, really, this is one piece of what is a broader set of requirements to try to move toward unified bookkeeping under GAAP accounting, try to state ultimately all of our assets and liabilities so that we have a better idea of where we are; and, I suspect if we do that, we'll find that we're in bigger trouble than we think.

Mr. CLINGER. Thank you very much, Senator. I, again, commend you for your leadership and look forward to working with you and to see this enacted into law before your untimely departure from the Senate. We will miss you.

Senator EVANS. It's one of the priorities I intend to work on during this second session.

Mr. APPLEGATE. Thank you, Mr. Clinger.

Mr. Ballenger?

Mr. BALLENGER. Senator, I thank you for coming.

In the discussion that we have had here and also in your statement you mention that the Federal Government encompass 154 separate accounting systems. How far are we away—and you're guessing, I'm sure it can't be anything more than a considered opinion—from being able to consolidate these accounting, changing the accounting systems to make it possible to really come forward with a practical capital budget. Or, do you need a good accounting system before you can do that?

Senator EVANS. Well, it would certainly help and it would make it more accurate, but I don't think we need wait for all of these 154 systems to be either merged or to be made, at least, so similar that we can have a true GAAP-type accounting system for the Federal Government in order to move toward a capital budget. We can do it; it won't be as good as it will be when we move toward standardized bookkeeping, but I don't think we need wait. If we did, it would be a long time. I think that it's going to take a very substantial period of time to get all of these separate accounting systems pooled into some unity. Probably, the biggest length of time will be to convince those separate agencies that they ought to do it.

Mr. BALLENGER. Have you, in your own mind, estimated a time period? I know, in North Carolina, when we implemented a capital budget it took us approximately four years to merge into one accounting system; and we don't have anywhere near 154 separate entities to consider. How long did it take in Washington when you decided to switch to a capital budget?

Senator EVANS. Well, your experience in North Carolina is pretty similar to that in Washington.

We began the process—and it takes sometime to just identify where you are when you're as loosely tied together as we are now at the Federal level, or as we were in many States—it just takes some time to identify where you are; and, then it takes some time

to educate; then it takes some time to convince; and, then it takes the time to actually go through the process. It took us the better part of four or five years; so we were in the same boat.

I would guess to do the job, if we started today and if we finished the job and had a clearly unified system of accounting at the end of seven or eight years, that would be a major accomplishment. Maybe we can do it faster, but I wouldn't bet on it.

Mr. BALLENGER. Thank you, sir.

Mr. APPLEGATE. Thank you, Mr. Ballenger.

Mr. Shaw is on the phone; I don't know whether he has any questions that he would like to ask? He has no questions.

I wasn't here at the outset, Senator, and so I'm sorry I didn't get a chance to hear your expert testimony and to hear of your bill.

I am not an expert at all on capital budgeting; however, you apparently have some arguments that sound pretty good. From a pragmatic standpoint and, I suppose, a philosophical standpoint, if it does everything that you say that it ought to do and it would be best for the country, then why do those who are in positions of power—such as, I understand, Jack Brooks—oppose such a progressive direction?

Senator EVANS. I do not know why Representative Brooks would oppose it, specifically. I think that some at OMB and, perhaps, some in Congress are fearful that if you were to get into a capital budget, it would offer ways for people to diminish their interest in eliminating the deficit; it would offer an open door to try to push things that truly are operating expenses into the capital budget by the way you identify them. And those are dangers we have to be careful of.

But I think we can handle the second one—the inappropriate identification of capital projects—simply by careful definition and careful oversight.

As far as the first is concerned, in an exchange we had earlier, I think that it would probably focus much more accurately the intention of Congress, and of the people, on our deficit if we separated the deficit out and said each year: here is a deficit we expect of $140 billion which is just credit card deficit, it's to handle the operating expenses; and, here is $40 billion, or $30 billion, or whatever it is, that really represents an investment in future assets which we can identify and provide some value to.

I think that would not diminish, but rather enhance the intensity with which we focus on the real deficit, the true deficit which, in my view, is that portion of the deficit just like a credit card—used to finance the things we want without really expecting to pay for them, at least not on a regular basis.

Mr. APPLEGATE. Let me ask you just one other question.

In the Economic Summit, just as a matter of trying to educate me to some of these things, in order to find some monies to help reach the objectives they're trying to achieve, they have some asset sales. What kind are you talking about? There are two different kinds of assets—tangible and intangible. What are they? I think they were talking about asset sales of somewhere around $5 billion. There's some from what I can see that are intangible, some within the Veteran's Administration and then some other possibly tangible capital assets; can you——

Senator EVANS. It is my understanding that the largest element of their assets sales that they were talking about were the REA loans that they wanted to sell; and, I think they are now finding that it maybe will not bring as much as they once thought it would in terms of benefit to the Federal Government. But I think we've always got to be very careful of asset sales; that's a legitimate thing to do whether you're a business or an individual or a government, that's a perfectly legitimate thing to do as long as you are not lulled into believing that when you reduce the deficit one year by the sale of $5 billion worth of assets, that that's going to help you the next hear. It may make it more difficult because you have no more assets to sell and you've still got that $5 billion to get at.

So, I think we sometimes fool ourselves; and, here again, I think if we carefully are calculating both the assets and the liabilities in conjunction with a capital budget, just our mindset, our understanding in a more detailed sense—all of us—of our budget and what's happening to it, would start to minimize that kind of shenanigans.

Mr. APPLEGATE. Thank you.

Mr. Shaw?

Mr. SHAW. Thank you, Mr. Chairman.

There's nothing that I like better than to sit here and listen to someone who I'm in total agreement with.

Senator, I would join with Mr. Clinger in expressing great regret over your departure from the Senate, because you have certainly been a leader on this most important issue over there.

I'd also like to highlight what you just said with regard to asset sales, and tie this into something you said earlier, and that is that opponents of capital budgeting are concerned that there would be some shenanigans in reducing the deficit, or it would decrease our desire to decrease the deficit, or there might be trickery or slight-of-hand. These are the same people who are advocating the asset sales, which makes absolutely no sense whatsoever. It's like showing a profit in a corporation by selling the plant. It's absolutely ridiculous; and this capital budgeting would stop that.

Incidently, I just left a meeting downstairs where the Public Building and Grounds is passing a bill that I have filed with regard to time financing, which gets us over another hump which is very important.

I talked to Jim Miller, just briefly, who was leaving another hearing, on water resources and, obviously, his mind is on things right now other than capital budgeting and time financing. But, he made a statement to me which I think is very important and one that I think you're also aware of—that what we need to do is attack the whole problem of the accounting methods of the Federal Government.

I think this legislation is the most important piece of that reform. We need to go further, but this has got to be the most important piece of the whole thing.

I intend to write the President and write Mr. Miller a letter suggesting strongly that the President might want to include our bill—your bill, Mr. Clinger's bill, my bill, which is the same bill—or, at least, a statement on the philosophy behind this bill, in the State of the Union Address.

I think that might get us over the hump and get this thing moving and, hopefully, if we put enough energy on it this year or what's left of this year, and next year, that the President will give us a good send-off next year, so that we can make it truly happen before you leave the Senate and before the end of the 100th Congress.

Would you care to join in such a letter?

Senator EVANS. Oh, indeed I would.

Mr. SHAW. I know Mr. Clinger would and I'm sure Joe DioGuardi would. I'll get the letter prepared and circulated, and maybe we can get that included in the State of the Union. It's something that the President has touched on before but, unfortunately, with all the other problems over in the White House, they really haven't focused on it; but, maybe if the President has a quiet year ahead of him, and a lot of us hope that he will—that he will focus on this and what could be, really, one of the landmark pieces of legislation of his Presidency.

Senator EVANS. I really think it could be. It doesn't draw huge crowds, as we can see from today's hearing, but that's not what's important. What is important is what it can do for all of us, and for the people of the country, in better understanding really where we are. It is a piece of—and I'm sure my colleague will testify on some other elements of this—the real need for bookkeeping changes.

And, frankly, I'm also a cosponsor on the Senate side of a proposal to move to a two-year budget concept, which would be an interesting change for me, because as Governor, I said, gee, a biannual budget, that's old fashioned; we've got to move to an annual budget.

Well, we didn't do it and it's fortunate that we didn't do it, because we leave ourselves with a budget framework for a two-year period which gives us more time, through the legislature and the Executive Branch, to spend more time on oversight which we don't do very well. And, I think that if we had a two-year budget framework at the Federal level focusing one year of a Congress on building that two-year budget framework, the agencies of Government would have a better sense of what they could plan for; we could then spend, in the second year, much more of our effort on the kind of oversight on what we have done that would tell us an awful lot about what we ought to be doing in the future.

Mr. SHAW. Is there a similar bill on the House side?

Senator EVANS. I do not know. In fact, there are several bills on the Senate side that focus on a two-year budget framework in a somewhat different way.

Mr. SHAW. There may very well be, but I don't know. Will you have your staff send that information on that two-year budget bill over; I'd be very interested in taking a look at that.

Senator EVANS. Sure; we will indeed.

Mr. SHAW. It sounds like an excellent idea.

Well, again, thank you for your good work. It is not a sexy issue, but it is revolutionary; and it could change not only the bookkeeping but the philosophy of how we conduct ourselves as a Government and how we make certain budgetary decisions, which will change the course of our country to a certain degree.

Thank you, Senator.

Mr. CLINGER. Mr. Chairman?

Mr. APPLEGATE. Mr. Clinger?

Mr. CLINGER. I want to ask that a copy of Senator Evans' bill, S. 1528, be admitted into the record along with the paper he alluded to: "How Do Private Firms Fare Under Federal Government Accounting Procedures."

Mr. APPLEGATE. Without objection.

Senator EVANS. I thank you for doing that because I had intended to and had forgotten. I think both of them will be helpful additions to the record.

Mr. APPLEGATE. Senator, as a Democrat to a Republican, I extend to you my heartfelt best wishes for all that you seek in your future, and we extend good luck to you. You obviously have done an outstanding job in your State, never having lost an election in a State that is basically Democrat. And, I saw where one of the reasons you're leaving is because of the long and costly campaign; I think that we've all agreed to that. However, it's unfortunate that you weren't in the House, because you said that you expressed this point about the lack of cooperation in the Senate; we have no such thing here, we all are in perfect harmony.

Mr. SHAW. I would add, Mr. Chairman, if I may, to this that having looked at what goes on in the Senate and what goes on here, if you wish to continue your political life, you might find it much more civilized to run for the House and join us here. We could certainly use you.

Mr. APPLEGATE. See the kind of cooperation we have?

Senator EVANS. As John Quincy Adams did after his Presidency and served long and well in the House of Representatives.

Mr. SHAW. I've looked at that race, particularly with our senior Senator Chiles, leaving, and I look at the lack of rules and discipline in the Senate, and it took me exactly two seconds to decide that I was very happy where I am, sir.

Senator EVANS. Well, you know the old story, which I'm sure you've heard many times, of Thomas Jefferson coming back after the deliberations on the Constitution and having tea with George Washington, and he asked about the two-House legislature which had been created; and, as was the custom in those days, they poured their tea into the saucers to cool it; and George Washington says, ah, just as you pour the tea in your saucers to cool it, so we pour the passions of the House into the coolness and deliberations of the Senate.

Mr. SHAW. That's a wonderful story.

Senator EVANS. Or words to that extent. I'm not sure that's a true, modern description of what the Senate does, but they take enough time to cool almost anything.

Mr. APPLEGATE. Thank you again, Senator Evans.

Senator EVANS. Thanks very much.

[Senator Evans' prepared statement, along with S. 1528 and the paper "How do private firms fare under Federal Government Accounting procedures" follows:]

A Federal Capital Budget

Testimony to the
House Public Works Subcommittee on
Economic Development

Senator Daniel J. Evans
December 9, 1987

Mr. Chairman, I congratulate you for scheduling a hearing on this important topic. Capital budgeting is not a subject that appears on the front page of newspapers, but is as important to our budget decisions as many issues that do receive headline attention.

When I came to the Senate in 1983 I was shocked that federal budget and accounting procedures were in most cases vastly inferior those we had used in state government. For the most part, the federal approach is awkward and confusing because we rely on a jerry-built system that is simply incapable of meeting the demands of a trillion dollar budget.

During my time here I have spent many hours trying to develop a workable -- and politically palatable -- capital budget plan for our country. I believe that modernizing and streamlining our accounting systems and budget procedures is an absolutely essential complement to spending restraint if we truly desire to place ourselves on sound fiscal footings for the future.

Mr. Chairman, this morning I will focus on two points. First, I will discuss S. 1528, "The Federal Capital Budget Act of 1987" which I introduced on July 22 and which Congressman Bill Clinger has introduced in the House. Second, I will offer a few general observations on capital budgeting and other budget and accounting practices from my perspective as a former Governor.

Before describing the provisions of S. 1528, however, I wish to express my appreciation for the valuable assistance of Charles Bowsher, the Comptroller General, and his staff in helping to develop this legislation. As I am sure you discovered during

yesterday's hearing, the General Accounting Office (GAO) continues to play a valuable leadership role in improving our antiquated financial management practices.

Mr. Chairman, through "The Federal Capital Budget Act" we seek to identify, define and present separate operating and capital components of the Federal budget while maintaining a unified budget. Our goal is to provide what the existing budget does not -- adequate and clear information on the revenues, expenditures, surplus/deficit amounts, and financing requirements for capital activities of the Federal Government. In the bill we also seek to distinguish between capital and operating activities in a manner which does not hinder indentifying the resources needed to meet the government's capital infrastructure needs.

I should highlight the important fact that this legislation retains a unified budget concept. This proposal does not attempt to reduce the Federal budget deficit by taking capital expenditures off-budget. A capital budget that remains part of the unified budget, may help us better define "what is a balanced budget"? As we move in the direction of a balanced budget, we need to explore more fully whether it even makes sense for the Federal Government to balance its annual budget under current bookkeeping practices.

The private sector and a large majority of state and local governments have set a financial example which the federal government would do well to emulate. They all recognize the many benefits of maintaining a distinction between capital and operating expense:

- Focuses attention to a greater degree on the deteriorating physical infrastructure of the nation and allows us to make more rational investment decisions;

- Promotes intergenerational equity by burdening future generations with debt service only for activities that provide future tangible benefits (capital);

- Provides more equitable budget treatment of capital activities by avoiding the current "front-end loading" of the full costs in the first year; and

- Shows that borrowing to finance capital investments is accompanied by an increase in the nation's assets.

In addition, state and local governments find that a separate capital budget creates a clearer picture of capital needs and related financing requirements. By highlighting the connection between a capital project and financing requirements, state and local governments can better cope with more restrictive options for raising revenues and meet the balanced budget obligations which many of them face.

As Governor, I attempted to create budget and accounting processes that could be easily understood by the individual taxpayers and businesses of Washington State. This effort culminated in a report issued to who in effect are the stockholders of Washington State. Integral to this effort were implementing budget and accounting practices that conformed with Generally Accepted Accounting Principles (GAAP) and separating the capital and operating budgets.

With the recognition that there are obstacles to business and government operating absolutely alike, I believe it is to our benefit to mirror as closely as possible the financial practices of the private sector. Most states are setting the course and establishing proper standards. Thirty-seven states have distinct capital budgets. Twenty-six states report that they prepare financial statements in conformance with GAAP; 11 report partial conformance; and 10 states plan to prepare such financial statements in the near future.

Mr. Chairman, I believe that capital budgeting can help considerably in restoring order to our fiscal house. However, that alone is not enough. We also must consolidate our accounting.

Currently, the Federal Government uses 154 separate accounting systems. Each one is tailored to the needs of the particular agency using the system. There is little coordination of financial information. GAO is working on this problem and has already developed programs which can help bring greater rationality to the federal accounting process.

Perhaps, Mr. Chairman, the most constructive course Congress can take is to change our financial mindset. At least part of this change can come from emulating certain practices in the private sector, where companies must maintain books of sufficient coherence that investors are not misled and stockholders can ascertain what management is up to. Congress should consider itself as the Board of Directors of the Federal Government and with this responsibility ensure that citizens living outside the beltway understand how their government fares financially.

If a study completed by Michael Boskin, Professor of Economics at Stanford University, is any indication, we are doing a good job misleading our Government's stockholders. In his paper, Dr. Boskin compares private sector corporate financial status under Generally Accepted Accounting Principles (GAAP) to the same numbers cast under what he refers to as "Generally Unacceptable Federal Government Accounting Procedures". He concluded that if General Motors had used Federal accounting procedures in 1984, they would have shown a net loss of $4.82 per share.

But according to GAAP, they made more than $14 profit per share during that year. These are two sets of books using exactly the same figures. It is time the public -- who hold all the stock in this government -- have a better idea about what their elected managers are doing.

In closing, Mr. Chairman, Congress will continue to be faced with problems created by a weak fiscal foundation. With the Gramm-Rudman-Hollings Plan requirement of a zero-deficit by 1992, however, debate on establishing a capital budget appears timely. I hope the Committee will continue to pursue this issue and I offer my assistance in making it become a reality.

Submissions for the Committee record:

-- S. 1528, "The Federal Capital Budget Act of 1987" and a section-by-section description of the legislation.
-- A paper prepared by Dr. Michael J. Boskin.

II

100TH CONGRESS
1ST SESSION

S. 1528

To improve budgetary information by requiring that the unified budget presented by the President contain an operating budget and a capital budget, and for other purposes.

IN THE SENATE OF THE UNITED STATES

JULY 22 (legislative day, JUNE 23), 1987

Mr. EVANS (for himself, Mrs. KASSEBAUM, and Mr. DURENBERGER) introduced the following bill; which was read twice and referred to the Committee on Governmental Affairs

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A BILL

To improve budgetary information by requiring that the unified budget presented by the President contain an operating budget and a capital budget, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Federal Capital Budget Act of 1987".

SEC. 2. STATEMENT OF FINDING AND PURPOSE.

(a) STATEMENT OF FINDING.—The Congress finds that the existing budget does not provide adequate information on the revenues, expenditures, surplus/deficit amounts, and fi-

nancing requirements for capital activities of the Federal Government, and obscures the distinctions between capital activities and operating activities in a manner which hinders identifying the resources needed to meet the Government's capital infrastructure needs.

(b) PURPOSE.—It is the purpose of this Act that the unified budget present a capital budget and an operating budget which provides better and more relevant information on the revenues, expenditures, and financing requirements of Government programs and activities funded by those budgets.

SEC. 3. CAPITAL AND OPERATING BUDGETS.

Title 31, United States Code, is amended by inserting after section 1105 the following new section:

"§ 1105a. Capital and operating budgets

"(a)(1) The budget of the United States submitted by the President under section 1105 of this title shall be a unified budget composed of a separate operating budget and a separate capital budget which taken together equal the unified budget.

"(2) Actual, estimated, and proposed amounts contained in the unified budget and its operating and capital budget components shall be presented, at a minimum, as the following separate elements:

"(A) operating budget, (i) operating revenues, (ii) operating expenses, (iii) operating surplus/deficit, (iv) depreciation expense, and (v) adjusted operating surplus/deficit;

"(B) capital budget, (i) capital revenues, (ii) capital investments, and (iii) net capital financing requirements; and

"(C) unified budget, (i) gross financing requirements, (ii) adjustment for depreciation expense, and (iii) net financing requirements.

"(3) The capital budget shall represent only the major activities, projects, and programs which support the acquisition, construction, and rehabilitation of capital assets. All other activities, projects, and programs shall be represented in the operating budget.

"(b)(1) The budget submitted by the President shall be presented in a form which distinguishes, at the account, function, agency, and Governmentwide levels the actual, estimated, and proposed appropriations, receipts, and expenditures which are part of the capital budget component of the unified budget and those that are part of the operating component as described in subsection (a).

"(2) In addition to the basis on which information required under paragraph (1) is provided, the President shall present such information using accrual accounting procedures

and provide a reconciliation of the amounts presented under this paragraph with the corresponding amounts presented under paragraph (1). The information required by this paragraph may be provided as a special analysis to the budget the President submits.

"(c) In this section—

"(1) 'capital assets' means physical assets and financial assets, but does not include consumable inventories;

"(2) 'physical assets' means tangible assets whose ownership resides or will reside in the public domain; which typically produce services or benefits, including for national defense and security, for more than one year; and have an initial price per unit of equal to or more than $500,000. Such assets include but are not limited to—

"(A) roadways and bridges;

"(B) airports and airway facilities;

"(C) mass transportation systems;

"(D) waste water treatment and related facilities;

"(E) water resource projects;

"(F) medical facilities;

"(G) resource recovery facilities

"(H) public buildings;

"(I) space and communication facilities;

"(J) railroads;

"(K) defense facilities;

"(L) major weapons platforms; and

"(M) strategic petroleum reserves and mineral stockpiles;

"(3) 'financial assets' means interests in, and claims against, governments, enterprises, organizations, and individuals and their resources which are represented by a legal instrument (such as stocks, bonds, debentures, notes, and other securities) acquired from foreign governments, states and their political subdivisions, corporations, associations, individuals, and others;

"(4) 'consumable inventories' means tangible assets, including stockpiles, supples, and inventories, which typically are consumed within one year or have an initial price per unit of less than $500,000;

"(5) 'unified budget' means a budget in which revenues and expenditures are consolidated to display totals for the Federal Government as a whole;

"(6) 'operating revenues' means all receipts other than those identified in paragraph (11), including profits and interest earned on financial assets;

"(7) 'operating expenses' means all expenditures, other than those identified in paragraph (12) including interest payments on debts and loan subsidy costs;

"(8) 'the operating surplus/deficit' means the difference between operating revenues and operating expenses;

"(9) 'depreciation expense' means a systematic allocation of a portion of a physical asset's original cost (excluding national monuments and land) owned by the Federal Government, and financed by the appropriation accounts for which the capital budget required under subsection (a) of this section applies;

"(10) 'adjusted operating surplus/deficit' means the total of the operating surplus/deficit and the depreciation expense;

"(11) 'capital revenues' means receipts derived from the repayment of principal invested in financial assets, and taxes, collections, and receipts dedicated by statute, for the acquisition, construction, and rehabilitation of capital assets which relate to the activities, functions, and programs represented by the capital budget;

"(12) 'capital investments' means expenditures, including those under grants, contracts, and leases,

which are for the acquisition, construction, and rehabilitation of capital assets;

"(13) 'net capital financing requirements' means the amount capital investments exceed capital revenues;

"(14) 'the gross financing requirements' means the total of the adjusted operating surplus/deficit and the net capital financing requirement; and

"(15) 'net financing requirements' means the gross financing requirement less the depreciation expense.".

SEC. 4. CONFORMING AMENDMENTS.

Section 1112 of title 31, United States Code, is amended—

(1) in subsection (c)(1), by inserting "criteria, principles, and standards for determining the contents of the operating and capital budgets required under section 1105a of this title, and" after "including".

(2) by adding the following subsection at the end thereof:

"(g) The Comptroller General shall review the implementation of section 1105a of this title as the Comptroller General deems necessary. The review by the Comptroller General shall include but not be limited to determining whether actual and proposed appropriations, receipts, and ex-

penditures presented in the capital budget represent activities, functions, and programs which support the acquisition, construction, and rehabilitation of capital assets.

"(h) Eighteen months after implementation of this legislation, the Comptroller General shall report to the Congress on the appropriateness of the $500,000 threshold for classifying items in the capital budget section of the unified budget. The report shall recommend, if appropriate based on the results of the Comptroller General's review, a new threshold or means of calculating such threshold.".

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How Do Private Firms Fare Under Federal Government Accounting Procedures?

Examples* of Generally Unacceptable Federal Government Accounting Procedures (GUFGAP)

by

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* These examples are meant to highlight various accounting and conceptual issues in the federal budget and related documents. They are drawn from material in my forthcoming book, The Real Federal Budget, Harvard University Press. I am deeply indebted to Brad Barham and Matt Cameron for assistance in preparing these examples. Nothing contained herein is meant to convey any information or judgement concerning the activities or accounting procedures of the firms used as examples.

1. Introduction

The federal government's accounting procedures differ greatly from generally accepted accounting principles (GAAP). There are undoubtedly a variety of reasons for this, including important differences between government and private activity, historical accident, political decisions, etc. Among the many unusual features of federal government accounting procedures are the failure to separate capital and current accounts, the lack of provision for expected future losses in many loan and loan guarantee programs, the exclusion of a variety of items, etc.

Such accounting procedures may lead to inefficient government decisions at the agency level, e.g., in the decision to rent versus purchase equipment, the terms of loans or guarantees, and the sale of government assets. Thus, future costs or cost savings may be given systematically insufficient weight in budgetary decisions. The additional information conveyed by more complete and accurate financial reporting for the federal government, while potentially a valuable input into better government budgeting, can also be abused or misused. Uneconomic public investment could be justified as not adding to current operating expenditures or the deficit, for example.

In order to highlight the implications of some of these unusual features of federal government accounting procedures, we present below some examples of the financial reporting of some of the most prominent corporations in the United States, using various features of federal government accounting procedures. We have not attempted to adjust each and every item to make it consistent with all features of the federal government's accounting procedures. Rather, we have taken specific examples of federal budget accounting anomalies and applied them selectively to the financial reporting of corporations to highlight the

potential problems.

The results are striking. For example, General Motors had one of the most profitable years in the history of the automobile industry in 1984. However, if General Motors did not have a separate capital account and treated its huge investment expenditures as current expenses, as is done in the federal budget, it would have reported a large net loss. This would have had the by-product of transforming $417 million in taxes due into a large net operating loss carry-forward, reducing future tax liabilities.

SeaFirst Bank, whose difficulties stem heavily from the Penn Square fiasco, reported a $180 million loss before taxes, and a $91 million loss after taxes, in 1982 (implying approximately a $90 million tax refund). SeaFirst reported a $288 million loan loss provision that year. Of this amount, only $186 million were on bad loans realized in 1982, the balance being provisions for expected future loan losses. Following current federal government accounting procedures and thereby recording only the net loan losses actually incurred in 1982, SeaFirst becomes slightly profitable and its huge tax refund becomes a small tax liability.

IBM had a net income of $11.6 billion in 1984, and an after-tax net income of $6.6 billion. Following federal government accounting procedures, if IBM had recorded all of its 1984 investment expenditures as a current expense, it would have reduced its reported net income to $3.6 billion, and its after-tax income to approximately $2.0 billion. Thus, IBM would have reduced its federal tax liability by approximately $3.5 billion.

Among major corporations, IBM is a rarity as it is a large net

creditor. Were IBM to record only one-half of its receipts as interest income as if one-half of its loans were recorded off-budget, as is done by the federal government, its net income would be reduced still further to $3.2 billion, and its after-tax income to $1.8 billion. The earnings per share and the return on stockholders equity would likewise have plummetted with these "adjustments".

Finally, General Electric Corporation reported in 1984 an operating income of $2.8 billion and an after-tax net income of $2.3 billion. The return on total capital and stockholders equity were about 18% and 19%, respectively, and earnings per share were over $5. If GE had recorded all of its investment expenditures as a current expense, it would have reduced its operating income to $357 million, slightly over 10% of reported operating income. On the other hand, if General Electric had reported the revenue from capital asset sales as current revenues, as is often done in the federal budget and as President Reagan proposes in the fiscal year 1987 budget plan for reducing the federal deficit, GE's operating income would have risen to $4.2 billion and its after-tax net income to $2.8 billion. Its return on total capital and return on stockholders equity would have soared, as would its earnings per share and tax liability.

There are numerous problems with private accounting procedures and many conceptual difficulties in setting up an appropriate accounting system for private firms. Many of these are compounded when we examine the activities of the federal government.

These examples, however, clearly illustrate how arbitrary, and in some cases, quite misleading, the use of current federal government accounting procedures can be in presenting either an accurate record of federal government transactions or an accurate guide to budgetary

choices in the future. Rather than using generally accepted accounting principles (GAAP), the federal government's accounting procedures might best be labeled as "generally unacceptable federal government accounting procedures" (GUFGAP).

General Motors - 1984

	Operating Income[1] $millions (After Taxes)	Return on Shareholders' Equity	Earnings per Share $	Taxes Due ($ million)
GAAP	4,516.5 (2,710.9)	18.7%	14.22	1,805.1
GUFGAPI	-1,530.7	-6.3%	-4.82	Negative Present Value[2]

Source: General Motor's Annual Report for 1984.

GUFGAPI: We include current investment expenditures as a current expense.

Note: 1. Operating income figures are net income prior to extraordinary items, such as asset sales, where relevant.

2. Net operating losses to be carried forward which will reduce future tax liabilities.

International Business Machines Corporation
1984

	Operating Income $millions (After Taxes)	Return on Average Stockholders' Equity	Earnings per Share $	Taxes Due[1] ($ million)
GAAP	11,623 (6,582)	26.5%	10.77	5,041
GUFGAPI	3,583 (2,028)	8.2%	3.32	1,555
GUFGAP2	3,183 (1,805)	7.3%	2.95	1,378

Source: IBM's Annual Report for 1984.

GUFGAPI: Includes current investment expenditures as a current expense.
GUFGAP2: Records only 1/2 of interest income as if one half of IBM's loan assets are recorded off-budget through the equivalent of the Federal Financing Bank.

Note: 1. Taxes due approximated using the effective tax rate of 43.4% reported in 1984 rather than the statutory rate of 46%.

General Electric - 1984

	Operating Income $million (After Taxes)	Return on Total Capital	Return on Average Stockholder's Equity	Earnings per Share $	Taxes Due[1] ($ million)
GAAP	2,845 (2,280)	17.9%	19.1%	5.03	1,065
GUFGAP1	357 (593)	4.7%	5.0%	1.31	275
GUFGAP2	4,191 (2,790)	20.0%	23.4%	6.15	1,295

Source: General Electric Annual Report for 1984.

GUFGAP1: Includes current investment expenditures as a current expense.
GUFGAP2: Includes revenue from capital asset sales as current revenues like President Reagan's plan for asset sales as deficit reduction measures. Under GAAP, generally accepted accounting principles, capital gains or losses from asset sales, not total sale revenues, are reported as extroadinary gains or losses, separate from net income from normal operations.

Note: 1. Taxes due approximated using the effective tax rate of 31.7% reported in 1984 rather than the statutory rate of 46%.

2. The operating income figure of $357 million before taxes and ~~$593~~ million after taxes is due to the presence of extraordinary itmes not included in operating income.

Mr. APPLEGATE. Next, our colleague from New York, Representative DioGuardi.

Welcome.

Mr. DIOGUARDI. Thank you.

Good morning. I think this is excellent, because the testimony given by the Senator is, I think, a great starting point for what I have to say. I think you'll find that my testimony will not only complement and supplement what he has already said, but put it in a broader category, Congressman Shaw and Congressman Clinger, so that I think you'll understand, and I think you have understood, the need for not only a capital budget, but for other reforms that may be even more important at the same time.

I've got a short statement, and then I'll be available for questions and a few other comments, but I felt I should at least make a statement to begin this hearing.

Mr. Chairman, thank you for giving me the opportunity to testify before your subcommittee this morning on the subject of capital budget.

As many of you already know, I was a practicing CPA when I was elected to Congress and served 22 years as a partner with one of our nation's largest accounting firms. I believe my background in the private sector gives me a somewhat unique perspective on the Federal budget and the issues we are discussing today.

The Public Works Committee's interest in the capital budget is not surprising and should be applauded. Implementation of a capital budget for public works and other investments in our Nation's infrastructure would clearly demonstrate to the American people the important work being done by this committee and dispel the false perception some have that public works are nothing more than parochial pork barreling.

However, as I see it, the capital budget is just one component of what needs to be a complete overhaul of our present Federal budgeting and accounting systems. If the thrust behind moving to a capital budget is to improve the overall decision-making process and help Congress to prioritize where tax dollars are spent, I fear that its adoption is going to be of little help so long as we continue to rely on other Federal budgeting and accounting systems, which are now in complete shambles.

If, on the other hand, we move ahead with across-the-board Federal budgeting and accounting reform, and implement the accounting and financial reporting requirements that the Federal Government requires of every publicly traded corporation in the United States in order to protect their investors against fraud, a capital budget would be a very valuable public policy tool.

In other words, before debating whether or not we should adopt a capital budget, we need to fully examine the soundness of the systems which are the underpinnings of the current budgetary process.

For example, New York City had a capital budget in the 1970s, but still went belly-up because of its other budgeting and accounting systems that were in a complete mess. And, as I just said, the sad truth is that the Federal Government systems are not much better; they may, in fact, be a lot worse.

Comptroller General Charles Bowsher, head of the highly respected General Accounting Office, has testified numerous times on Capitol Hill that our financial management systems are too numerous, antiquated, and inadequate to provide us with reliable information on the effectiveness of Government programs.

In another study that was done by the Systems Committee of the President's Council on Management Improvement concerning "a strategic plan for the Federal financial management," you find other shocking things. And that study was unique in that it did not depend on the assessments of outside critics; it's results came from those on the firing line. Financial management executives in the Federal departments and agencies who were interviewed for the study, get this, "regarded less than 50 percent of Governmental accounting and financial reporting systems as capable of producing timely, accurate, and relevant information for management decision making; 61 percent," they said, "of the systems cannot provide the data necessary for assessing management performance." And, "35 percent of the systems we use were considered incapable of providing sufficient data to support the allocation of funds, and 33 percent do not provide effective control over the accountability of assets."

These are the 154 systems that the Senator referred to. This is the crisis we face in Government today—the underpinnings of the system upon which we are now trying to decide a capital budget.

These problems have been highlighted by the Gramm-Rudman law. In attempting to meet Gramm-Rudman targets, Congress has had no idea as to where would be the best place to make these cuts. The information simply does not exist in order to make these tough policy decisions.

Furthermore, our current systems have allowed us to play games readily with the budget and mask economic reality. The smoke and mirrors spending reductions and revenue enhancements used to meet the Gramm-Rudman targets are a constant reminder of the flaws and the failures in our system, and the need to run our Government's finances in a more businesslike manner.

Now, Mr. Chairman, I've heard a lot of people criticize this approach and say that Government is not a business and should not be run like one. However, I believe opponents of reforming our budgeting and accounting systems are using this argument as a smoke screen to obscure the true cost of Government, both domestic and defense programs included.

The real issue should be one of accountability to the public. Let's give the public a dollar's worth of goods and services for a dollar's worth of taxes; they are not getting it. Even though the Federal Government is not a profit-making entity, American taxpayers have a right to know that their tax dollars are being spent wisely and in the most efficient manner possible. And, for whatever personal reasons you might have, I am sure most of you would agree that that is not occurring today.

Again, I applaud your committee for attempting to make some sense out of our spending decisions in Congress. But I would caution you to remember that a capital budget only becomes a real alternative when considered in the context of a complete Government budgeting and accounting reform overhaul.

Thank you very much. I'd like to, before concluding the testimony, introduce into the record several clippings.

One, in The Wall Street Journal on November 6, 1987, entitled "GAAP"—that's generally accepted accounting principles—"Budget Gaps Will Surprise." This was written by me at the time, and I think that you will be surprised and shocked to see the difference in Government accounting if you were to put the four years of President Carter and the first four years of President Reagan on the system that the Government imposes on the public—on public corporations—with a capital budget; it's just unbelievable, the differences that are there.

There's also another clipping from the November 20 issue of The Wall Street Journal that describes the summit budget process and why it's floundering and, again, alludes to the problem in the system.

And, then finally a speech that I've been giving around the country—I've visited twelve cities this year as a CPA who happens to be a Congressman—and it's to push a bill that I have right now before Congress, H.R. 3142, to bring a chief financial officer to the United States of America since we don't have one. And, this bill, in its enhanced version, would require/mandate generally accepted accounting principles, and financial management reform.

So, I thought I would put that for the record just to complete the perspective that your committee should be looking at in terms of deciding on a capital budget.

Thank you, Mr. Chairman.

Mr. APPLEGATE. Without objection, it will be entered into the record along with your prepared statement.

[The article referred to follows:]

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FRIDAY, NOVEMBER 6, 1987

GAAP's Budget Gaps Will Surprise

By Joseph DioGuardi

The events of the past two weeks have shown us that it is easier for President Reagan to reach an agreement with the Communists in Moscow on nuclear missiles than it is for him to reach an agreement with the Democrats in Congress on the budget deficit. And so long as congressional Democrats insist that new taxes are the only way to reduce the gap, it is likely to remain that way.

It should be clear by now that real progress on reducing the deficit will come about only through a new way of thinking. Despite the fact that the growth rate of federal spending has been significantly reduced under the Reagan administration, the president has been tagged as the biggest deficit spender in history. But now, with the budget summit, the president has a golden opportunity to shake this label by radically reforming the budget process and demonstrating to the American public that deficit spending has in fact been reduced, not increased, during his administration.

He could bring about a meaningful budget process by requiring the government to use Generally Accepted Accounting Principles, the accrual-basis budgeting and accounting system that is required of every publicly owned company in order to prevent fraudulent and misleading financial reporting. Moreover, GAAP would show that Reagan administration deficits are lower than those compiled by Jimmy Carter.

The federal government currently uses a cash-basis budgeting and accounting system for measuring government spending. This cash-basis system is nothing more than a simple measure of how much money an entity takes in and how much it spends. While the cash-basis budget system provides us with important quantitative information concerning our government's cash flow, it tells us absolutely nothing about the qualitative nature of these expenditures.

Replacing the cash-basis system with GAAP would radically alter the manner in which we construct our budgets and show us the real cost of government programs. GAAP records economic events as they occur, giving us credits for assets that we will have for years to come, and putting liabilities on the books at the time they are incurred. If Congress creates a new program that will require future federal funding, the cost under GAAP would be reflected in our current accounts. Likewise, if Congress makes an investment in a capital item that will have value for years to come, that value would be recognized.

Instead, Congress has used smoke and mirrors to achieve imaginary budget "savings." Last year, to reach Gramm-Rudman-Hollings deficit-reduction targets, Congress shifted the pay date for military personnel to one fiscal year from another. While Congress has made moves to prevent such abuse in the future, under GAAP it would never have been possible for Congress to get away with this budget chicanery: The obligation to pay military personnel would still be recorded on the books as part of the current budget regardless of when it was to be paid.

This brings us back to the Carter-Reagan budget comparison. In 1986, Arthur Andersen & Co. attempted to get a clearer picture of the true nature of our federal debt by estimating U.S. budget deficits under GAAP from 1974 to 1984 and comparing them with our regularly used cash-basis system. What we find from the years 1976 to 1984 reveals some interesting facts about just who really is responsible for our deficit and national debt.

The accompanying tables compare the Carter-Reagan cash-basis and GAAP budgets during those years using both nominal and 1984 dollars. (Comparative figures in this article are in 1984 constant dollars.)

In 1980, the last full year that Mr. Carter controlled the budget, while the cash-basis deficit totaled $93.5 billion, the estimated GAAP deficit for that same year was a staggering $408.3 billion. Meanwhile, four years later, while Ronald Reagan was taking the heat for increasing the cash-basis deficit to $185.3 billion, the estimated GAAP deficit stood at $333.4 billion, a deficit reduction of nearly $75 billion from Carter's 1980 level. Furthermore, Mr. Carter's total estimated GAAP deficits over the 1977-80 period were $56.5 billion higher than Mr. Reagan's total for 1981-84.

A significant portion of Mr. Reagan's cash-basis deficits is actually the liquidation of liabilities incurred by the Carter administration, but whose costs were not recorded at that time because of the cash-basis system. In addition, the GAAP deficits tell us that President Reagan has spent proportionately more in his budgets on capital items whose benefit should be amortized over future fiscal periods. Conversely, President Carter spent proportionately more on items that were consumed immediately, providing no benefit to future periods. As a result, President Reagan, who has significantly reduced the growth of federal outlays as demonstrated by GAAP, is being blamed for a cash-basis debt that is largely the result of spending decisions made by Jimmy Carter.

The bottom line, however, is that GAAP shows us serious and dangerous flaws in the federal government's reliance on cash-basis budgets that will not be cured by line-item vetoes, a balanced-budget amendment or tax increases. Cash-basis budgeting is the same system that led to the financial collapse of New York City in 1974. The fatal flaws in the cash-basis system were so apparent to the federal government at that time that it required New York City to adopt GAAP accounting as one of the conditions for a federal bailout.

At long last, Congress is beginning to recognize the danger of sloppy federal accounting and financial management practices. In August, I introduced bipartisan legislation with 56 co-sponsors to create the Office of a Chief Financial Officer of the United States. Among the duties of the CFO would be producing the budget for the U.S. using GAAP.

Even though GAAP budgeting shows that the president is making progress on deficit reduction, he has been reluctant to support the adoption of a budgeting system that would recognize a doubling of our debt through its more accurate reflection of all government liabilities. But that was before black Monday.

It is time for the president to help put economic reality on the books. If the president and Congress retreat to their caves and ignore the truth of the budget, the bears on Wall Street may come out of hibernation on a full-time basis.

Rep. DioGuardi (R., N.Y.) is a former partner at Arthur Andersen & Co.

Two Ways to Assess the Deficit

(In billions of dollars)

The Carter Years

	CASH BASIS ANNUAL DEFICIT			GAAP BASIS ANNUAL DEFICIT		
YEAR	NOMINAL DOLLARS	PERCENTAGE OF GNP	1984 DOLLARS	NOMINAL DOLLARS	PERCENTAGE OF GNP	1984 DOLLARS
1977	$53.6	2.9%	$ 85.9	$224.6	12.1%	$ 359.8
1978	59.0	2.8	88.4	215.8	10.3	323.2
1979	40.2	1.7	55.5	256.8	10.9	354.9
1980	73.8	2.9	93.5	322.2	12.5	408.3
		2.6%*	$323.3†		11.5%*	$1,446.2†

The Reagan Years

	CASH BASIS ANNUAL DEFICIT			GAAP BASIS ANNUAL DEFICIT		
YEAR	NOMINAL DOLLARS	PERCENTAGE OF GNP	1984 DOLLARS	NOMINAL DOLLARS	PERCENTAGE OF GNP	1984 DOLLARS
1981	$ 78.9	2.7%	$ 91.3	$264.7	9.2%	$ 306.3
1982	127.9	4.2	138.5	314.0	10.3	339.9
1983	207.8	6.4	215.6	395.3	12.3	410.1
1984	185.3	5.2	185.3	333.4	9.3	333.4
		4.6%*	$630.7†		10.3%*	$1,389.7†

*Average †Total

Source: Arthur Andersen & Co.

THE WALL STREET JOURNAL.

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REVIEW & OUTLOOK

The Summit Flounders

As we went to press, the summiteers had reached no final agreement on a deficit-reduction package. Absent an agreement of some sort, Gramm-Rudman's automatic, across-the-board cuts begin at midnight. Unless, of course, Congress, like Harold Lloyd hanging from the arm of a huge clock, votes to delay Gramm-Rudman's grim tolling bell.

This failure is no surprise. The current system under which Congress and the executive allocate federal resources is broken. And in its current design it will never work.

Members of Congress don't spend vast sums of money on re-election campaigns so they can cast votes to withdraw funding from their most supportive constituents. House Rules Committee Chairman Claude Pepper, in the middle of the summit negotiations, has just proposed a vast $25 billion long-term health-care plan. We oppose Mr. Pepper but at least admire his honesty of purpose. Better this than to promise false spending reductions and vague revenue enhancements to "calm the markets."

Democratic Rep. Butler Derrick was quoted in the Journal yesterday as saying the point of the budget summit "is to make government not as large and cumbersome, and to cut back on it." Precisely. All "the markets" and critics of Washington want is concrete proof that the federal colossus is under someone's rational, long-term control. No significant progress will be made on this until the system is reformed—politically, technically and intellectually.

The political reform is a line-item veto. The item veto is not a conservative ploy to eviscerate Congress and its programs. Democratic presidents desired it. Democratic governors cherish it. The item veto's function is to force the executive and legislative branches to bargain and balance the national interest against narrow constituent interests. The current appropriations process reflects the kinds of corruptions bred by a closed system—pork-barreling, off-budget appropriations, "self-financing" trust funds, the recording of current spending in future accounts or the folding of new outlays into continuing resolutions. The item veto would throw a light into this vast darkness.

The technical reform is GAAP. Serious consideration should be given to adopting some form of Generally Accepted Accounting Principles, as proposed by New York's Rep. Joseph DioGuardi. Currently, the government operates on a cash-basis accounting system that is an incentive to fogging up the books. Accounting reform would provide both the political marketplace and the financial markets a more rational basis for evaluating the national government's commitments. (Such a system might, for instance, have offered a more sobering picture of the real costs of Mr. Reagan's catastrophic-health insurance plan.)

The intellectual reform Washington needs to examine is privatization. Only in Washington is privatization regarded as some sort of ideological takeover plot. In truth, it is a public management technique gaining popularity among states and localities to prudently and efficiently allocate budget resources. This year an amendment to the House defense authorization bill actually killed the department's ability to privatize some ancillary services provided to military bases.

Each of these ideas has critics. But the critics, especially in the Washington community, offer absolutely no alternatives of their own. The budget summit—a "grand compromise"—is the establishment's idea of a pragmatic solution. It is instead the equivalent of putting a highway tractor in park and flooring the accelerator.

After this failure, the rationalizations are appearing in print, the most popular being that polls show the public really doesn't want outlays cut. We thought this was the United States, not the Roman Colosseum. If we wanted government run wholly by opinion polls, we could just put the tough decisions on Cable News Network and have the public vote thumbs up or down by calling a 900-number. Presumably the public elects leaders, not robots.

We have been told that this White House no longer has the stomach to press for an item veto. Possibly so. If not, the next administration will have to. We need no one to tell us that this Congress doesn't have the stomach to press for a rational budget system. Real change will ultimately require political change.

Accordingly, Republican dissent from the impending summit compromise is a healthy sign. Pretending to do something in the current spotlight would be politically worse than doing nothing. The signatories to this deal automatically become part of the problem. By opting out, the Republicans can preserve a serious issue for next year's elections and the Congress that follows.

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A CHIEF FINANCIAL OFFICER FOR THE UNITED STATES

by the Honorable Joseph J. DioGuardi (R-NY)

Editor's Note: *This is the first in a series of opinion pieces on accounting issues which can be pulled out and kept. They will appear occasionally and explore subjects of concern to the accounting community and nonprofit accounting.*

The accounting profession is receiving an increasing amount of attention on Capitol Hill. Many people in Congress would like to see the profession take a greater role in blowing the whistle on financial fraud and abuse in the private sector. They believe this would help put an end to the kinds of scandals that have recently rocked Wall Street and our entire nation.

However, if there is one true scandal going on today in the United States that accountants should let the public know about, it is the manner in which the Federal government is managing the books of our nation. Many corporate executives would be likely to face jail sentences if they utilized the same accounting practices that are routinely employed in hundreds of Federal offices across our nation. Simply put, our nation's financial management systems are in ruins.

The Gramm-Rudman deficit reduction law and the "smoke and mirrors" means of reaching its targets is a painful reminder to us of the poor quality of accounting in the Federal government. Some systems are not in very good shape, and many don't tell us if we're making good decisions on cutting programs.

Sadly, there is nothing new about this sad state of affairs. For years, the General Accounting Office's (GAO) famous blue-covered reports have been telling us the same story: Our departments and agencies are a veritable jungle of special purpose, incompatible, antiquated accounting systems producing unreliable, and often irrelevant financial information. One recent GAO study, moreover, reports that 53% of agency accounting systems do not conform to GAO accounting principles, standards and related requirements. In short, Federal financial management is in shambles and there is little accountability to the American taxpayer for the revenues spent on their behalf.

A bill I have introduced in the House of Representatives with 56 of my colleagues, the Federal Financial Management Improvement and Public Accountability Act of 1987 (H.R. 3142), is designed to end all this and put in place the linchpin of financial discipline that is nowhere to be found in Washington.

H.R. 3142 would:

1) Establish an independent Office of the Chief Financial Officer of the United States within the Executive Office of the President of the United States for the purpose of providing government-wide direction and coordination of financial management activities;
2) Establish an office of the Assistant Secretary for Financial Management within each executive agency; and
3) Create a Federal Financial Management Council chaired by the Chief Financial Officer (CFO) and composed of the Assistant Secretaries of each executive agency.

In addition, the CFO would be responsible for producing annual consolidated financial statements for the Federal government using generally accepted accounting principles.

Other voices besides my own and that of the GAO have called attention to the inadequacy of Federal accounting systems and the lack of accountability inherent in the existing Federal financial management system. The Grace Commission dealt at length with the problem, and one can also look to a September 1985 study by the Systems Committee of the President's Council on Management Improvement concerning a "Strategic Plan for Federal Financial Management."

That study is unique in that it does not depend on the assessments of outside critics. Its results come from those on the firing line: financial management executives in Federal departments and agencies. Those interviewed for the study regarded less than 50% of governmental accounting and financial reporting systems as capable of producing timely, accurate and relevant information for management decision making. 61% of the systems cannot provide the data necessary for assessing management performance; 35% of the systems were considered incapable of providing sufficient data to support the allocation of funds, and 33% do not provide effective control over and accountability for assets.

The extent to which the government as a whole departs from basic accounting textbook requirements—to say nothing of common sense—defies logic. An earlier GAO study, Managing the Cost of Government, pointed out for example, that agency budgeting and accounting for program costs are largely done on different bases, and are isolated from one another. Budgets are requested and justified in terms of programs and projects, such as infant health care or dams for

flood control. Accounting and other financial reports, however, often focus on appropriations and categories of expenses such as travel or personnel, without relating them to the particular programs or projects for which the money was requested and approved.

As well as producing bad financial information, inadequate accounting systems are a pervasive source of government waste. In the case of both faulty internal control evaluations and faulty accounting system compliance assessments, the GAO has cited the Office of Management and Budget's (OMB) failure to develop adequate guidelines as a principal cause. But something more fundamental is at issue.

Despite OMB's best intentions, the development of such guidelines may require more time, resources and expertise—and the actual process more leadership—than OMB can provide, or is likely to provide under the current system. OMB's lack of resources, and frankly, the secondary role of financial management to budgetary considerations, hampers the Office's ability to give adequate emphasis to financial management matters.

While it appears that OMB finally is giving financial management the attention it deserves by recently announcing their own appointment of a chief financial officer, it is a highly specialized area which deserves independent, top level attention in its own right.

It does not now have that status within OMB. Despite the number of financial management improvement initiatives that have been undertaken, no structure or mechanism has been developed to improve financial management on a government-wide basis and assure not only continuity of effort across successive administrations, but systematic progress toward a set of established, long term financial management goals.

Instead, almost the opposite is true. Financial management leadership responsibilities and functions are seriously fragmented and disorganized, resulting in inconsistencies, overlap and duplication.

Federal financial management functions are split among three central agencies in the executive branch: OMB, the Office of Personnel Management (OPM) and the Department of the Treasury, the various executive branch agencies and the GAO in the legislative branch. None of these entities has clear cut responsibility for oversight and direction of the Federal government's financial management operations and activities. In addition, financial management responsibilities have frequently been shifted from one central agency to another; and in each central agency, financial management functions must compete with a number of other assigned responsibilities for their fair share of attention.

There is a missing link in the Federal government. The financial management leadership void must be filled and a CFO within the Executive Office of the President would achieve this goal.

Instituting a Chief Financial Officer for the United States would be a quantum leap forward in addressing the issue of Federal financial management accountability and it is appropriate to highlight several key components of the Federal Financial Management Improvement Act.

First, creation of an independent office for the CFO. A great deal of thought has been given to the difficult question of where a CFO function should be placed. At one time or another, OMb, the Treasury Department or a new office of Federal Management have all been considered as alternatives. In my opinion, the best organizational approach would be a new, independent office in the Executive Office of the President. History has shown that financial management functions placed in other organizations do not receive the attention they deserve.

Second, duties of the CFO. The CFO will have responsibility for operational financial management leadership—comparable to the responsibility accorded a controller in the private sector.

Third, term of office for the CFO. Financial management improvements have a long gestation period. Progress cannot be interrupted by changes in priorities and direction from administration to administration. Obviously, a certain amount of dislocation will occur under the best of circumstances, but I have attempted to insure maximum, long term consistency by establishing a CFO tenure of ten years.

Fourth, creation of the position of Assistant Secretary for Financial Management. The establishment of this position will insure top level, department-wide attention to the implementation of financial management initiatives and activities at the agency level; eliminate inconsistencies that exist among agencies in the status and structure of financial management operations; and eliminate internal agency overlap, duplication, and inconsistency in financial management activities.

Finally, creation of a Federal Financial Management Council. This Council will be composed of the CFO and the agency-level Assistant Secretaries for Financial Management. The Council will provide an important avenue of communication and interchange between the central financial management function and its counterparts in the departments and agencies—resulting in more effective implementation and coordination of financial management initiatives.

Gramm-Rudman was called a bad idea whose time had come. A Chief Financial Officer for the Federal government is a good idea whose time is long overdue. Sound financial management practices are not just accountants' issues. It is not just a Republican issue and it is not just a Democratic issue. Colleagues on both side of the aisle can agree on the clear need for action in this vital area. If we do not give our efforts to build fiscal discipline into the system a solid foundation of valid financial information and genuine financial discipline, the entire structure is capable of collapsing right around us.

Republican Congressman Joseph J. DioGuardi represents New York's 20th District and is a member of the Board of Directors of API.

Mr. APPLEGATE. I was interested in one thing that you stated when you were talking about a capital budget. If it's adopted you said, it will be of little help as long as we continue to rely on other Federal budgeting and accounting systems which you say are in shambles. What, specifically, are you referring to?

Mr. DIOGUARDI. Well, we have tremendous structural and systemic problems in the U.S. Government today when it comes to numbers. Not the least of which is that there are only four CPAs, believe it or not, in the U.S. Congress today—that's House and Senate—and we know we have over 260 attorneys. But you've got a tremendous imbalance in the kind of thinking that should be applied in spending a trillion dollars. And when I say spending a trillion dollars, that's the good news, that's what on the books.

You cannot believe what's off the books around here. You cannot believe the role that our voting card plays as the most expensive credit card in the world, because what we do mostly with the current accounting system is defer to the future much of the cost of Government, whether it's capital or operating expenses.

And that's the key point that the Senator was trying to make—that it is not enough just to make a distinction between the debt and the assets when it comes to capital expenditures. The biggest problem we face today is the huge amount of debt that's off the books right now, for the current operations of this Government, that are being passed on to the future; because there seems to be a mentality around here that we must disguise the true cost of Government because we've got to get elected or reelected every two years.

So, politics is forcing us not to address the real issue. The two issues we face, to answer your question more specifically, is, number one, the 154 accounting systems that the Senator alluded to. Chuck Bowsher of the GAO, the Comptroller General, is making tremendous steps in the right direction. It's going to take some time but they expect to get all of these systems—many of which do not correspond right now to GAO standards, let alone generally accepted accounting principles—to a basis where they are compatible and unified so that we can really compare, measure, and understand what is going on around here.

The next step, once you get by the systemic problem, is the accounting principles that we're using. We are now using the most archaic accounting system anyone ever created. It's actually worse than the one that New York City used, the one that we required New York City to get off of in 1976 as a price for the loan. We're still using that system and worse. And New York City had a capital budget. We still don't have a capital budget. In fact, 37 of the 43 States that responded to the Comptroller General's survey two years ago have a capital budget. We don't.

So, we must get, I believe, the underpinnings in shape, and I believe it's going to require some form of generally accepted accounting principles, some form of the system that the Securities and Exchange Commission now imposes on the public—now imposes on public corporations—before they're allowed to sell one share of stock or one bond to the public.

We sell tens of billions of dollars of bonds here every month, and the public doesn't get one piece of paper. There's no accountability

here whatsoever. So we've got a lot to go before a capital budget would become a meaningful tool to the United States Government.

Mr. APPLEGATE. So what you're saying is that we are going down the same road as New York?

Mr. DIOGUARDI. We are past the road that New York took; we have disguised it—the real debts of this country. And there's a statement; it is signed every year by the Comptroller of the United States, who happens to be a CPA, Chuck Bowsher, and the Secretary of Treasury; it's a prototype that is not advertised, you have to write for it—I order five boxes and I send it to every Member of Congress every year as a CPA who happens to be a Congressman; and, if you look at the debts of this country, the operating debts that apply to contingencies, guarantees, accrued pensions for civil service, accrued pensions for military, accounts payable, even if you forget social security and try to tell the people that's not a debt, you're talking about a balance sheet that would have a minimum of $4.5 trillion in debt, with social security at least $6 trillion in debt.

And our assets are no where near that. Just look at that balance sheet. We have passed New York City. We are, by any standard, right now bankrupt except that we are depending upon our kids to raise taxes in the future, when we're not here to pay the price, in order to pay all these debts.

Mr. APPLEGATE. Let me ask you this about H.R. 3142 that you introduced; it would help to establish an independent office of the Chief Financial Officer of the United States within the Executive Office of the President, etc.; and you also call for creating a Federal Financial Management Council. Is this something that's going to replace the existing offices that are in effect now—OMB or any of the others?

Mr. DIOGUARDI. No. It's going to be the linchpin that will finally take the duplication that's going on in Government today in all the various agencies—Office of Personnel Management, the GAO, the Office of Management and Budget, and the Treasury Department—there is no one agency that's focused on financial management massaging the numbers. The whole place, Mr. Chairman, is budget driven, and budget driven on the wrong system—the cash basis. We live from year to year; we rob Peter to pay Paul; we stay one step ahead of the sheriff; we put out fires. All we do around here is react. No one is looking ahead.

We need a Chief Financial Officer, someone who's going to go beyond the budget process to understand what's happening; and the need for the Federal Finance Council is to have a mirror image of the CFO in every one of the 18 major agencies and departments, with a dotted line past the Secretary. Because I don't want a Cap Weinberger who may be carrying the Government's or the President's Order on Defense to put a lid on a number that I need as a Congressman to determine the true cost of Government.

So, I want to see a CFO, unlike the OMB who likes the concept but is resisting the placement in the Executive Office of the President with a 10-year term much like the Comptroller General, a-political, who transcends partisan politics so that we finally, in Congress, representatives of the people, get the true information we need. And that's the reason why we need it. And the basic problem

is that OMB— it's all B, there's no M—it's budget driven; they've got a couple of people running around with management titles, but their not looking at financial management.

Treasury is concerned with one thing: where is the cash, drive the IRS to raise more, change the system. And, when we appropriate, we force the Treasury to either write a check or sell bonds. The Treasury Secretary is not interested in anything but cash flow.

The Office of Personnel Management, again, huge amounts on payroll; they're not interested in management, it's a hiring and firing agency. And when you go talk to the Comptroller General, Chuck Bowsher, he supports this concept. He says, I'm not the CFO; I'm the one who audits what you're doing; if you make me the CFO, I'm no longer independent. He says, Joe, go back to Accounting 101. And he's right. So we need a linchpin. This is not going to be another layer of bureaucracy; this is going to be the Rosetta Stone to finally putting things in place so we can find out the true cost of Government before this great country goes downhill in the future and we'll never know why.

Mr. APPLEGATE. Thank you.

Mr. Shaw?

Mr. SHAW. Thank you, Mr. Chairman.

I compliment the gentleman from New York for a most impressive testimony.

I'd like to first of all point out to you that half of the Members of Congress who are in this room are CPAs.

Mr. DIOGUARDI. You're right, and you're one of them, Congressman Shaw; I know that.

Mr. SHAW. I really have no questions. You, obviously, are well-versed in what you say. You very obviously believe in it. I believe what you say; I'm not quite a doom-sayer as you are as to the bankruptcy of the Government; however, you are absolutely right that under our present accounting system there is really no way of knowing where we are, and it is certainly archaic.

I support you. As a matter of fact, I believe I'm a cosponsor of one or two of your bills on this particular subject.

I do believe, however, that this capital budgeting is a most important cog in a wheel, perhaps the most important cog in a wheel of accounting reform. But it is only one cog. I'm quite hopeful that we can at least get this in place as a foothold in the door to come up with some sanity in accounting.

Yesterday we had a witness who actually placed the Federal deficit at, I think, $153 billion, as I recall, by using capital budgeting. So he was telling us that the deficit for 1986 really wasn't as bad as it appears to be, but he used for depreciation the figure of $50 billion which he said was generally accepted. I've given that some thought and I'm not quite sure I agree with that. I think we are using up our infrastructure and our other capital assets a lot quicker than at $50 billion a year; however, taking that figure— that's sets the deficit at some $150 billion under the capital budget.

I just say you've been a strong force in the Congress for change; keep it up. I hope you will join with us in a letter to the President making the suggestion that he make this his centerpiece of legislation for his last year in the Presidency, and that he express that to us in his State of the Union Address. I think that's really the only

way we're going to get the entrenched budget now in use out of here so we can put in, at least, the beginning of some reform.

Thank you.

Thank you, Mr. Chairman.

Mr. DIOGUARDI. May I just comment, Congressman Shaw, on something you said?

Mr. SHAW. Yes, please do.

Mr. DIOGUARDI. Because it ties back to the testimony before.

There are so many aspects of implementing a capital budget and you've just kind of touched on one—the level of depreciation; and we heard from the Senator's testimony or, at least, the answer to the Chairman on what would be a capital asset. I just want to make a comment on that, because some very large questions will have to be answered even on that.

Once you decide that you want a capital budget, you can't imagine the opportunity for mismanagement using a capital budget that there is unless you start to define what is capital, how you're going to depreciate things; and that's another problem. That shouldn't prevent you from installing a capital budget, but I just wanted to direct you to the work that's being done right now by a very important group and it's called the Government Accounting Standards Board. The former Comptroller General, Elmer Staats, is right now leading on this issue. Now, the Government Accounting Standards Board right now is not concerned with the Federal Government. They're trying to come up with a form of generally accepted accounting principles including capital budgeting for the States. They want it now at State reporting. And New York State and, I know, Illinois, and California are way ahead of the curve on this.

But, the point is that we are going to have a very useful body of information shortly, once that board finishes its work, because it's independent; it's made up of some of the best thinkers in society; Elmer Staats, himself; and, they're going to try to define what is a capital asset in the public domain. And I would hope that this committee would, as a part of the its deliberations if it goes forward to recommend a capital budget, try to piggyback on the work that's being done, and not try to reinvent the wheel; because there are going to be huge questions as to how capital spending differs for a public entity such as the U.S. Government versus a business entity. I just felt that you should know that. Depreciation schedules will also be part of that, Congressman Shaw.

Mr. SHAW. I appreciate your adding that.

I would just add to what you said that I think it is most important that when we do get a capital budget—the definition of what is to be capitalized—that it be limited to tangible assets with a useful life at least in excess of one year and possibly two, that you don't get your other type of expenditures—which might be investing in the future— don't get that mixed up into a capital budget, otherwise you're going to have a worse situation.

Thank you, sir.

Mr. APPLEGATE. Thank you, Mr. Shaw.

Mr. Clinger?

Mr. CLINGER. Thank you very much, Mr. Chairman.

I like to define capital as everything that's under the jurisdiction of the Public Works and Transportation Committee; that is my general idea of what is good capital budgeting.

Congressman DioGuardi, I want to commend you on the leadership that you have taken in this whole area of financial reform of the Federal Government. I know you are a tremendously articulate advocate for the position, as has been indicated. It is a tough load to carry because it's difficult to get people really excited or interested in the things that you're talking about.

Just as a matter of interest—you've spoken now around the country—what kind of response do you get? I assume the audiences you are speaking to are fairly sensitive to the problem, but have you been getting a friendly reception?

Mr. DIOGUARDI. Well, one good indication is the level of mail that Jack Brooks is getting. I'm beginning to see some action because the people that hear me around the country come up and say, well, Joe, why don't we hear any other Congressman or Senator saying this, you're making absolute sense. Whether I speak before Chambers of Commerce, accounting groups, or financial executive's groups, the response is unanimous—why is it happening. They just don't have enough information. And, what I ask them to do at the end of every one of my speeches is, do yourself a favor, make this country's system work; besides voting, do at least one other thing—send a letter to your Congressman, your Representative and both Senators, and send a letter to Senator Glenn praising him for what he's doing on Government Affairs with his bill to change, and ask Jack Brooks to get on the ball.

And send copies to my office because I want my staff to see that this is not an idle issue. Because they keep telling me, Joe, don't keep wasting your time on this, you're not going to get reelected. We've got to get back to drugs, housing, the environment, and things like that. So, I basically have to do this on my time because I have a pretty tough political staff. But, they're getting the message—they're seeing all this mail come in. People are responding so positively, it is unbelievable. If we could get more Congressman running around the country as I have, and getting on the tube, and getting into The Wall Street Journal because now we are at a new plateau, at least I am, on this issue.

You will see the system change. Right now there's no constituency for it because the public is not informed and the public doesn't understand what questions to ask, but we're fast turning that corner.

I sent letters to the President on this already, and to OMB directors; and I've gotten their responses; and I've told President Reagan in a letter recently, I said, Mr. President, this is your legacy, you did this for California; you put California on a capital budget. If you have now the opportunity before you leave to really set the record straight and, by the way, Mr. President, if you don't, whoever becomes the President here on January 1, 1989, whether he be Democrat or Republican, probably is going to put all the debts on the books, because they want to set the record straight and they're not going to take the time to segregate the Reagan deficit from the new deal deficit. It's going to be all yours.

That's sitting on his desk right now. Now, I've got people out there writing that same letter to the White House, so the answer, basically, is that there is a tremendous reception to this. We need to get more Members out there articulating this position, and you'll see the reception that it gets.

Mr. CLINGER. Well, I'm not an accountant but I think I understand the appeal of the kinds of things you're talking about, especially in terms of bringing some sort of order out of what is presently financial chaos in our reporting systems in the Federal Government.

But I see another advantage to the concept of a capital budget and that is as a planning tool. We don't really appreciate the magnitude of the problem of this country's infrastructure needs; we certainly haven't any idea what the cost to address the problem is going to be; and, to me, another tremendous benefit to a capital budgeting concept is that it would give you the kind of tool that you could do effective long-range planning to address problems. It's not going to go away. It only gets worse. And it's like the guy selling the Framm air filter, you know— you can pay me now or you can pay me later; if you pay me later, it's going to cost a lot more.

So, I think that the capital budgeting can be a very useful planning tool in addition to bringing some sort of order out of the financial fiscal chaos.

Let me ask you this, though: you've indicated. That a capital budget absent taking a hard look at some other reforms will not be effective. We've got 154 different accounting systems in use at the present time. It's already been indicated that it's going to take a long time to develop some sort of uniformity out of that. Do we have to wait until all that's resolved before we can move toward capital budgeting, or can we start now?

Mr. DIOGUARDI. My feeling is that you should start now, but my feeling is that you're going to come up with a lot of political pressure not to do that; and I've tested the water on this and let me give you the benefit of the responses I've gotten.

Thinking of this as an important tool, as you do, Congressman Clinger, because we spend—this year I think the military is going to spend $100 billion on assets and the other part of the Government is going to spend another $100 billion—so approximately $200 billion a year is on capital expenditures and we just lump it in with everything else. Now, superimpose that on everything that's been spent; and we don't have a balance sheet so we really don't keep an adequate track of what's out there that has use to the future and what's depreciated.

But, I went to visit, because I made such a big issue of this that the White House called me down and invited me to speak to Don Regan when he was there, Wallison, and the chief counsel who was apparently in charge of this at the time, and he hit me with a question that surprised me. He said, Joe, why is it that every economist that comes in here is against a capital budget, and every accountant who comes in here is for it. And I had to think about that for a minute. I don't know whether you're aware of this but the issue is that the economists, like the chairman before when he was here, see a capital budget without adequate changes in the accounting principles as a tool, as a vehicle for further disguises. They don't

trust Congress, having seen the lack of discipline. If we just look at the budget process right now and where we are—and I want to comment on that in a moment—selling assets in order to balance the books and, worse than that, on a recourse basis. Meaning that, if you don't get from these REA loans what you think you're going to get, come back to see us next year, we'll give you the money.

See, everybody knows how to play the game around here. As long as it doesn't get on the balance sheet, that's okay; it will come back next year to haunt us. So we just are trying to come up with $30 billion on a recourse basis which, to me, is unbelievable and that's why I have to vote against this process and this budget package, in spite of the President being for it.

The point is, these economists are in great fear that everyone around here, especially the staff of Congressmen and including Senators that have no financial training and are usually either history majors or political science majors, are going to understand how to play this game even better with a capital budget that doesn't introduce generally accepted accounting principles. And, no matter what you call it, whether it's unified, or no matter what you say, we know how well-versed or how good people are in taking things out of context and making arguments and then confusing people when it comes to numbers.

So, I have to agree with these economists. While I want to see us start immediately, my big fear is that if we don't impose generally accepted accounting principles and put not only the assets on the books but the liabilities I mentioned before, that already are part of the statement called a prototype—the consolidated statements of the United States Government—that you will find all kinds of shenanigans being played; but my feeling is that you're not going to be able to sell it, that these economists are so good and are so well respected—and this is the surprise I got— that you'll see them in front of Congress and other committees saying, we can't support this. And this bill will be killed, Congressman Clinger, from what I can see.

So, I would say that while you're pushing this, you should at the same time be pushing for some improvement; maybe it's not completely generally accepted accounting principles, but some improvement in the current system so that we can get true accountability to the public.

Mr. CLINGER. Thank you very much.

Mr. APPLEGATE. Thank you very much, Mr. Clinger.

I was very intrigued, very engrossed in your answer about the difference between the accountants and the economists. But I want to commend you, too, for coming before the committee, you and Senator Evans, and giving form to a subject which you already said isn't exotic, isnt' sexy. It isn't anything anybody's going to go out and buy a paper to read about except those who are directly involved and truly interested in it, yet it's probably the most important issue, perhaps, that's facing the country today.

I don't know your bill, or whether I agree or disagree with it; I'm not knowledgeable enough to totally understand, and I don't know who else is. But I do know that, as has been stated, the budget process in this country is in a shambles. I, frankly, disagree with the system that's in place now and along with the accounting

aspect of it. From what little I know; and I do think there have to be some changes made. What the answer is, I do not know.

But I commend you for coming before the committee and talking about it. Keep it up and make people aware of it and one day maybe something will be done.

Mr. DIOGUARDI. Thank you very much.

Mr. APPLEGATE. And thank you for appearing before the committee.

[Mr. DioGuardi's prepared statement follows:]

STATEMENT OF REP. JOSEPH J. DIOGUARDI

BEFORE THE

THE HOUSE COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION

SUBCOMMITTEE ON ECONOMIC DEVELOPMENT

HEARING ON

THE CAPITAL BUDGET

DECEMBER 9, 1987

Mr. Chairman, thank you for giving me the opportunity to testify before your subcommittee this morning on the subject of capital budgeting. As many of you already know, I was a practicing CPA when I was elected to Congress and served 22 years, 12 as partner, with one of our nation's largest accounting firms. I believe my background in the private sector gives me a unique perspective on the Federal budget and budgeting issues.

The Public Works Committee's interest in the capital budget is not surprising and should be applauded. Implementation of a capital budget for public works and other investments in our nation's infrastructure would clearly demonstrate to the American people the important work done by this committee, and dispel the false perception some have that public works are nothing more than parochial pork barreling.

However, as I see it, the capital budget is just one component of what needs to be a complete overhaul of our present Federal budgeting and accounting systems. If the thrust behind moving to a capital budget is to improve the overall decision-making process and help Congress to prioritize where tax dollars are spent, I fear that its adoption is going to be of little help so long as we continue to rely on other Federal budgeting and accounting systems which are now in shambles.

On the other hand, if we move ahead with across-the-board Federal budgeting and accounting reform, and implement the accounting and financial reporting requirements that the Federal

Government requires every publicly held company in the United States to abide by in order to protect their investors against fraud, a capital budget would be a valuable public policy tool.

In other words, before debating whether or not we should adopt a capital budget, we need to fully examine the soundness of the systems which are the underpinnings of our current budget. For example, New York City had a capital budget in the 1970s, but still went belly-up because its other budgeting systems were a complete mess. And as I just said, the sad truth is that the Federal Government's systems are not much better.

Comptroller General Charles Bowsher, head of the highly respected General Accounting Office, has testified numerous times on Capitol Hill that our financial management systems are too numerous, antiquated and inadequate to provide us with reliable information on the effectiveness of government programs.

These problems have been highlighted by the Gramm-Rudman law. In attempting to meet Gramm-Rudman targets, Congress has had no idea as to where would be the best place to make cuts. The information simply does not exist in order to make these tough policy decisions. Furthermore, our current systems have allowed us to play games readily with the budget and mask economic reality. The "smoke and mirrors" spending reductions and revenue enhancements used to meet Gramm-Rudman targets are a

constant reminder of these flaws and the need to run our government's finances in a more businesslike manner.

Now, Mr. Chairman, I have heard a lot of people criticize this approach and say that government is not a business and should not be run one like. However, I believe opponents of reforming our budgeting and accounting systems are using this argument as a smokescreen to obscure the true cost of government, for both domestic and defense programs.

The real issue should be one of accountability to the public. Even though the Federal Government is not a profitmaking entity, American taxpayers have a right to know that their tax dollars are being spent wisely and in the most efficient manner possible. And, for whatever personal reasons you might have, I am sure most of you would agree that that is not occurring today.

Again, I applaud the committee for attempting to make some sense out of our spending decisions in Congress. But I would caution you to remember that a capital budget only becomes a real alternative when considered in the context of complete government budgeting and accounting reform.

I

100TH CONGRESS
1ST SESSION

H. R. 3142

To establish the Office of the Chief Financial Officer of the United States in the Executive Office of the President to direct and coordinate Federal financial management, and to establish an Office of the Assistant Secretary for Financial Management in each executive department and an Office of the Controller in each executive agency.

IN THE HOUSE OF REPRESENTATIVES

AUGUST 6, 1987

Mr. DIOGUARDI (for himself, Mr. BOULTER, Mr. ANNUNZIO, Mr. HYDE, Mr. HOUGHTON, Mr. FRANK, Mr. COBLE, Mr. DONALD E. LUKENS, Mr. NEAL, Mr. HILER, Mr. ROTH, Mr. HUNTER, Mr. DORNAN of California, Mr. CRANE, Mr. CRAIG, Mr. WALKER, Mr. DENNY SMITH, Mr. RHODES, Mr. BLAZ, Mr. LAGOMARSINO, Mr. FAUNTROY, Mr. DREIER of California, Mr. GINGRICH, Mr. HASTERT, Mr. HERGER, Mr. EDWARDS of Oklahoma, Mr. IRELAND, Mr. KEMP, Mr. KASICH, Mr. MACK, Mr. PARRIS, Mr. SHAW, Mr. SMITH of New Hampshire, Mr. SOLOMON, Mr. TRAFICANT, Mr. WYDEN, Mr. CHANDLER, Mr. ACKERMAN, Mr. BARNARD, Mr. DELAY, Mr. GALLO, Mr. GEKAS, Mr. KYL, Mr. LELAND, Mr. MCDADE, Mr. MARTINEZ, Mr. MAVROULES, Mr. ROBINSON, Mr. SMITH of New Jersey, Mr. TORRES, Mr. TOWNS, Mr. WORTLEY, Mr. BUSTAMANTE, Mr. CLINGER, Mr. CONYERS, Mr. GILMAN, Mr. MCEWEN, and Mr. SAXTON) introduced the following bill; which was referred to the Committee on Government Operations

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A BILL

To establish the Office of the Chief Financial Officer of the United States in the Executive Office of the President to direct and coordinate Federal financial management, and to establish an Office of the Assistant Secretary for Financial Management in each executive department and an Office of the Controller in each executive agency.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Federal Financial Management Improvement and Public Accountability Act".

SEC. 2. STATEMENT OF PURPOSE.

The purpose of this Act is to—

(1) provide central direction to, and coordination of, Federal financial management activities by consolidating such activities within a single organizational structure; and

(2) provide for the production of adequate, accurate, timely, and consistent financial data for the use of the executive branch and the Congress in the financing, management, and evaluation of Federal programs.

SEC. 3. ESTABLISHMENT OF NEW POSITIONS.

(a) OFFICE OF THE CHIEF FINANCIAL OFFICER OF THE UNITED STATES.—There is established in the Executive Office of the President the Office of the Chief Financial Officer of the United States. The head of the Office of the Chief Financial Officer of the United States is the Chief Financial Officer of the United States (hereinafter in this Act to be referred to as the "CFO").

(b) ASSISTANT SECRETARIES FOR FINANCIAL MANAGEMENT.—There is established in each executive department an Assistant Secretary for Financial Management.

(c) CONTROLLERS.—There is established in each executive agency (as defined in section 17(2)) which is not an executive department (as defined in section 17(3)) a Controller.

SEC. 4. APPOINTMENT AND REMOVAL OF NEW OFFICERS.

(a) APPOINTMENT.—The CFO, the Assistant Secretaries for Financial Management, and the Controllers shall be appointed by the President, by and with the advice and consent of the Senate, without regard to political affiliation and solely on the basis of integrity and demonstrated ability in accounting, budget execution, financial analysis, systems development, public administration, and management analysis.

(b) TERM OF OFFICE.—

(1) CFO.—The term of office of the CFO shall be 10 years. A CFO may not be reappointed as CFO.

(2) ASSISTANT SECRETARIES FOR FINANCIAL MANAGEMENT AND CONTROLLERS.—The term of office of each Assistant Secretary for Financial Management and of each Controller shall be 4 years. Assistant Secretaries for Financial Management and Controllers may be reappointed to their respective positions.

(c) POLITICAL ACTIVITIES.—Subchapter III of chapter 73 of title 5, United States Code, shall apply to the CFO, the Assistant Secretaries for Financial Management, and the Controllers, notwithstanding any exemption which might otherwise apply.

(d) REMOVAL.—

(1) CAUSE.—The CFO, the Assistant Secretaries for Financial Management, and the Controllers may be removed from office for permanent disability, inefficiency, incompetence, neglect of duty, malfeasance, or a felony or conduct involving moral turpitude.

(2) COMMUNICATION WITH THE CONGRESS.—In case of removal of a CFO, an Assistant Secretary for Financial Management, or a Controller, the President shall communicate the reasons for such removal to the Senate and the House of Representatives.

(e) VACANCIES.—A vacancy in the position of the CFO, an Assistant Secretary for Financial Management, or a Controller shall be filled in the manner in which the original appointment was made. Any individual appointed to fill a vacancy in the position of such officer occurring before the expiration of the term for which the predecessor of such officer

was appointed shall be appointed only for the remainder of such term.

(f) COMPENSATION.—

(1) CFO.—

(A) IN GENERAL.—The CFO shall be paid at a rate not to exceed the rate of basic pay payable for level II of the Executive Schedule.

(B) PENSION PLAN.—There shall be established for the CFO a pension plan comparable to the pension plan established for the Comptroller General of the United States.

(2) ASSISTANT SECRETARIES FOR FINANCIAL MANAGEMENT AND CONTROLLERS.—Each Assistant Secretary for Financial Management and Controller shall be paid at a rate not to exceed the rate of basic pay payable for level IV of the Executive Schedule.

SEC. 5. DUTIES OF NEW OFFICERS.

(a) CFO.—The CFO shall do the following:

(1) Provide leadership, central direction, guidance, and monitoring of all executive agencies in the management of their financial activities and related financial reporting.

(2) Recommend to the President, the Congress, and the heads of the executive agencies methods, policies, and procedures concerning the use of financial

data which will enable effective management of the operations and activities of all executive agencies.

(3) Use an accrual method of accounting to prepare an annual report of the consolidated financial position of the Federal Government in accordance with generally accepted accounting principles adopted by the Comptroller General for such purpose.

(4) Publish and distribute 1 copy of the report described in paragraph (3) to each Member of the Congress and to each Governor of a State, and make 2,000 copies of such report available to the general public—

(A) for the first fiscal year beginning after the effective date of this Act, within 6 months after the end of the fiscal year; and

(B) for the second fiscal year beginning after the effective date of this Act and for all fiscal years succeeding such fourth fiscal year, within 3 months after the end of the fiscal year.

(5) Ensure that copies of the report are made readily available to the general public for a reasonable fee.

(6) Prepare the budget of the United States Government for each fiscal year and a budget forecast for the 5 fiscal years immediately following such fiscal

year (assuming the appropriations, expenditures, and receipts proposed in such budget) using the cash basis method of accounting, and prepare such budget and budget forecast using an accrual method of accounting, in accordance with generally accepted accounting principles prescribed by the Comptroller General for such purpose.

(7) Develop and maintain a strategic master plan for the financial management of the executive branch (which should be a 5-year plan that addresses such areas as system enhancements, staffing needs, technology improvements, required legislative actions, information requirements, and budget priorities) and ensure that the President and the Congress are kept fully and currently informed of the progress in implementing the plan.

(8) Coordinate and monitor the development of executive agency accounting and financial management systems for the purpose of establishing parity among such systems and ensuring consistency with principles and standards established by the Comptroller General.

(9) Ensure that the President and the Congress are kept fully and currently informed of the Federal Government's requirements for financial resources to correct deficiencies and improve the effectiveness of ac-

counting, financial system, and systems of internal controls.

(10) Maintain the central accounting and reporting records of the Federal Government.

(11) Establish, in consultation with the other members of the Federal Finance Council (established by section 8), government personnel qualifications and job descriptions for all executive agency financial management positions.

(12) Recommend to the President at least 3 individuals for each vacancy in the position of an Assistant Secretary for Financial Management of an executive department or a Controller of an agency, and provide additional recommendations for such positions to the President on request.

(13) Review and approve the financial management plan for each executive agency as well as the budget line item submission of each agency for its Assistant Secretary for Financial Management or Controller, as the case may be.

(14) Identify and establish financial management objectives and information requirements in consultation with the other members of the Federal Finance Council in order to define the data requirements of standards established by the Comptroller General for the use

of all executive agencies in the development and operation of their financial management systems (which are to be established within time periods prescribed by the CFO).

(15) Review the performance indicators developed by the head of any executive agency under subsection (d), and approve any indicator which the CFO determines is appropriate for the purposes described in such subsection.

(b) COMPTROLLER GENERAL.—The Comptroller General shall—

(1) prescribe the manner in which generally accepted accounting principles may be applied in preparing—

(A) the report of the consolidated financial position of the Federal Government and similar reports for departments and agencies of the Federal Government; and

(B) the budget proposed by the President for the United States Government for each fiscal year (and associated budget forecast) under the cash basis and an accrual method of accounting;

(2) audit the report of the consolidated financial position of the Federal Government prepared annually by the CFO;

(3) audit the performance indicators developed by the heads of executive agencies under subsection (d) which have been approved by the CFO; and

(4) report to the President and the Congress the results of each audit carried out pursuant to paragraph (1), and include in such report an evaluation of the performance of the programs described in paragraph (2) using the indicators developed for such purpose pursuant to paragraph (2).

(c) ASSISTANT SECRETARIES FOR FINANCIAL MANAGEMENT AND CONTROLLERS.—Each Assistant Secretary for Financial Management for an executive department and each Controller for an executive agency which is not an executive department shall—

(1) develop and maintain a strategic financial management plan for the department or agency, as the case may be, subject to the review of, and concurrence by, the CFO;

(2) participate in the appointment, professional development, and periodic evaluation of financial managers of the department or agency, as the case may be; and

(3) produce consolidated financial statements for the department or agency, as the case may be, in accordance with generally accepted accounting principles

prescribed by the Comptroller General for such purpose.

(d) DEPARTMENT AND AGENCY HEADS.—The head of each executive agency (as defined in section 17(2)) shall develop indicators (including measures of costs and benefits), subject to approval by the CFO, which may be used by persons who are not financial professionals to enable such persons to evaluate the performance of each program of the agency under which at least $25,000,000 has been expended in a single fiscal year (unless there has been a 3-year period in which less than $25,000,000 has been expended under such program).

SEC. 6. AUTHORITY OF CHIEF FINANCIAL OFFICER.

(a) ACCESS TO OFFICIAL INFORMATION.—The CFO may secure directly from any executive agency the information or reports necessary for the performance of the duties of the CFO. The CFO may require the head of any executive agency (as defined in section 17(4)) to prepare such reports as may be necessary to aid the performance of the duties of the CFO. The head of an executive agency shall furnish such information and reports to the CFO on request of the CFO. This subsection shall not be construed to require the head of an executive agency to violate any law, regulation, or Executive order.

(b) HIRING OF PERSONNEL.—The CFO—

(1) shall appoint and hire such officers and employees as may be necessary to perform the duties of the CFO, subject to the provisions of title 5, United States Code, governing appointments in the competitive service, and shall be paid in accordance with the provisions of chapter 51 and subchapter III of chapter 53 of such title relating to classification and General Schedule pay rates; and

(2) may procure temporary and intermittent services under section 3109(b) of title 5, United States Code, but at rates for individuals not to exceed the daily equivalent of the minimum annual rate of basic pay payable for GS–18 of the General Schedule.

(c) STAFF OF EXECUTIVE AGENCIES.—The head of any executive branch entity shall detail, on a reimbursable basis, any personnel of such agency to the Office (as defined in section 17(5)) to assist in the performance of the duties of the CFO on request of the CFO.

(d) CONTRACTS AND PAYMENTS.—The CFO may, to such extent and in such amounts as may be provided in advance by appropriation Acts, enter into contracts and other arrangements for studies, analyses, and other services with public agencies and with private persons and make such payments as may be necessary to perform the duties of the CFO.

SEC. 7. DEPARTMENT AND AGENCY BUDGET CHANGES.

The budget of each executive department and agency shall contain a line item for the Assistant Secretary for Financial Management or the Controller of the department or agency, as the case may be. Such line item shall be based on the strategic financial management plan for the department or agency, as the case may be.

SEC. 8. FEDERAL FINANCE COUNCIL.

(a) ESTABLISHMENT.—There is established in the executive branch the Federal Finance Council.

(b) COMPOSITION.—The Federal Finance Council shall consist of the CFO and all of the Assistant Secretaries for Financial Management of the executive departments.

(c) DUTIES.—The Federal Finance Council shall—

(1) assist the CFO in the identification and establishment of financial management objectives and information requirements of the executive agencies;

(2) assist in the development and implementation of financial management plans;

(3) comment on proposed major changes in financial management operations; and

(4) prepare option papers and recommendations regarding selected issues directly impacting financial management operating activities.

(d) CHAIR.—The Federal Finance Council shall be chaired by the CFO.

SEC. 9. TRANSFER OF FUNCTIONS.

The President shall, by Executive order, transfer to the Office—

(1) such functions (as defined in section 17(6)) of the executive agencies as the President determines are properly related to the functions of the Office and which, if transferred, would be consistent with their purpose and creation;

(2) such personnel, property, and records of such agencies as are related to the functions transferred under paragraph (1).

SEC. 10. TRANSFER AND ALLOCATION OF APPROPRIATIONS AND PERSONNEL.

(a) IN GENERAL.—The personnel employed in connection with, and the assets, liabilities, contracts, property, records, and unexpended balance of appropriations, authorizations, allocations, and other funds employed, held, used, arising from, available to, or to be made available in connection with the functions and offices, or portions thereof, transferred by this Act shall, subject to section 1531 of title 31, United States Code, be transferred to the CFO for appropriate allocation.

(b) LIMITATION ON USE OF UNEXPENDED FUNDS.—Unexpended funds transferred pursuant to this section may not be used for any purpose other than the purposes for

which such funds were originally authorized and appropriated.

SEC. 11. EFFECT ON PERSONNEL.

(a) SEPARATION AND COMPENSATION.—Full-time employees (except special Government employees) and part-time employees holding permanent positions who are transferred to the Office pursuant to this Act shall not, on account of such transfer, be separated or reduced in grade or compensation for 1 year after the date of transfer.

(b) TRANSFER OF EXECUTIVE SCHEDULE PERSONNEL.—Any person who, on the day preceding the effective date of this Act, held a position compensated in accordance with the Executive Schedule prescribed in chapter 53 of title 5, United States Code, and who, without a break in service, is appointed in the Office to a position having duties comparable to the duties performed by such person immediately preceding such appointment shall continue to be compensated in the new position at not less than the rate provided for the previous position, for the duration of the service of such person in such new position.

SEC. 12. INCIDENTAL TRANSFERS.

The President or his designee shall—

(1) make such determinations as may be necessary with regard to—

(A) the functions, offices, or portions thereof transferred by this Act, and

(B) the transfer of positions within the Senior Executive Service in connection with functions, offices, or portions thereof transferred by this Act; and

(2) make such additional incidental dispositions of personnel, assets, liabilities, grants, contracts, property, records, and unexpended balances of appropriations, authorizations, allocations, and other funds held, used, arising from, available to, or to be made available in connection with such functions, offices, or portions thereof, as may be necessary to carry out this Act.

SEC. 13. TRANSITION AUTHORITY.

The CFO may utilize the services of such officers, employees, and other personnel of the entities from which functions, offices, or portions thereof have been transferred to the CFO or the Office, and funds appropriated to such functions, offices, or portions thereof, for such period of time as may reasonably be needed to facilitate their orderly transfer.

SEC. 14. SAVINGS PROVISIONS.

(a) IN GENERAL.—All orders, determinations, rules, regulations, permits, grants, contracts, certificates, licenses, and privileges in effect at the time this Act takes effect, which have been issued, made, granted, or allowed to become

effective by the President, by any Federal department or agency or official thereof, or by a court of competent jurisdiction, in the performance of functions which are transferred under this Act to the CFO or the Office, shall continue in effect according to their terms until modified, terminated, superseded, set aside, or revoked in accordance with law by the President, by the CFO or other authorized official, by a court of competent jurisdiction, or by operation of law.

(b) EFFECT ON PENDING PROCEEDINGS AND APPLICATIONS.—

(1) IN GENERAL.—This Act shall not affect any proceeding (including notices of proposed rulemaking), or any application for any license, permit, certificate, or financial assistance pending on the effective date of this Act before any department, agency, commission, or component thereof, any function of which is transferred by this Act. Such proceedings and applications shall be continued to the extent related to any function transferred.

(2) ORDERLY TRANSFER OF PROCEEDINGS.—The CFO shall promulgate regulations providing for the orderly transfer of proceedings and applications continued under paragraph (1) to the Office.

(3) ORDERS.—Orders shall be issued in such proceedings, appeals may be taken therefrom, and pay-

ments shall be made pursuant to such orders, as if this Act had not been enacted. Orders issued in any such proceeding shall continue in effect until modified, terminated, superseded, or revoked by the CFO, by a court of competent jurisdiction, or by operation of law.

(4) CONSTRUCTION.—This subsection shall not be construed to prohibit the discontinuance or modification of any proceeding under the same terms and conditions and to the same extent that such proceeding could have been discontinued or modified had this Act not been enacted.

(c) EFFECT ON JUDICIAL AND ADMINISTRATIVE PROCEEDINGS.—Except as provided in subsection (e)—

(1) the provisions of this Act shall not affect judicial or administrative actions commenced before the effective date of this Act, and

(2) in all such actions, proceedings shall be had, appeals may be taken, and judgments shall be rendered in the same manner and with the same effect as if this Act had not been enacted.

(d) NONABATEMENT OF ACTIONS.—This Act does not abate any action or other proceeding commenced by or against any entity any function of which is transferred by this Act, or by or against any officer thereof in the official capacity of such individual as an officer.

(e) EFFECT ON PARTIES.—If, before the effective date of this Act, any entity or officer thereof in the official capacity of such officer, is a party to an action, and under this Act any function of such entity or officer is transferred to the CFO or the Office, then such action shall be continued with the CFO or other appropriate official of the Office substituted or added as a party.

(f) EFFECT ON JUDICIAL AND ADMINISTRATIVE REVIEW.—Orders and actions of the CFO in the exercise of functions transferred under this Act shall be subject to judicial and administrative review to the same extent and in the same manner as if such orders and actions had continued to be implemented by the entity or part thereof which had been exercising such functions immediately preceding their transfer. Any statutory requirements relating to notice, hearings, action upon the record, or administrative review which apply to any function transferred by this Act shall apply to the exercise of such function by the CFO.

SEC. 15. CONFORMING AMENDMENTS.

(a) IN GENERAL.—Within 180 days after the date of the enactment of this Act, the CFO shall submit to the Congress all necessary conforming amendments to the laws which contain the functions transferred to or vested in the CFO by this Act.

(b) PREPARATION OF THE BUDGET.—Section 1105(a) of title 31, United States Code, is amended by adding at the end the following:

"(26) a summary of how the use of accrual accounting procedures would affect the estimated expenditures, appropriations, and receipts of the Government in the fiscal year for which the budget is submitted.".

(c) COMPENSATION OF CFO.—Section 5313 of title 5, United States Code, is amended by adding at the end thereof the following:

"The Chief Financial Officer of the United States.".

SEC. 16. REFERENCES.

Any reference in any other Federal law to any entity or officer any function of which is transferred by this Act shall be deemed to be a reference to the CFO or component of the Office to which this Act transfers such function.

SEC. 17. DEFINITIONS.

As used in this Act:

(1) FINANCIAL MANAGEMENT.—The term "financial management" means the systems, controls, policies, and procedures of any executive agency which plan, account for, document, or report on—

(A) financial performance and control of resources; and

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(B) promotion of efficient use of financial resources such as financial planning, budget execution, accounting, financial information systems development and maintenance, financial analysis, debt and credit management, cash management and analysis, and reporting.

(2) EXECUTIVE AGENCY.—The term "executive agency" has the meaning such term has in section 552(e) of title 5, United States Code.

(3) EXECUTIVE DEPARTMENT.—The term "executive department" has the meaning such term has in section 101 of title 5, United States Code.

(4) HEAD OF AN EXECUTIVE AGENCY.—The term "head of an executive agency" means, with respect to an agency, the chief executive authority within the agency.

(5) OFFICE.—The term "Office" means the Office of the Chief Financial Officer of the United States, Executive Office of the President.

(6) FUNCTION.—The term "function" includes any duty, obligation, power, authority, responsibility, right, privilege, activity, or program.

SEC. 18. EFFECTIVE DATE.

This Act shall take effect 30 days after the date of the enactment of this Act.

Mr. APPLEGATE. We have coming before us now the Honorable Jessie Rattley, Mayor of Newport News, Virginia, speaking on behalf of the U.S. Conference of Mayors.

We welcome you to the Committee.

TESTIMONY OF HON. JESSIE RATTLEY, MAYOR, NEWPORT NEWS, VA, ON BEHALF OF THE U.S. CONFERENCE OF MAYORS

Ms. RATTLEY. Thank you very much.

First of all, my name is Jessie Rattley, I'm the Mayor of Newport News, Virginia, and I have served on the Newport News City Council for the last 17½ years.

I am here this morning testifying on behalf of the U.S. Conference of Mayors.

Mr. Chairman, I appreciate the opportunity to participate in this hearing on capital budgeting. I am not an accountant, I am not a CPA, I do have a degree, however, in Business Education so I have some knowledge of what I am talking about, and also I have dealt with a capital budget at the city level for the last 17 years.

Clearly, the Congressional budget process deserves considerable attention, given the rather perilous nature of the legislative calendar before Congress today. I certainly do not intend to offer recommendations on how the Congressional budget process might be improved or reformed; however, I will attempt, through my testimony here today, to bring to light some of the aspects of the capital budgeting process utilized by my city and also by many cities across this nation.

The Federal Government does not have a capital budget separate and distinct from its operating budget, and I'm sure that's no news to you. Capital budgeting spending is incorporated within the regular day-to-day expenditures, and clouds the true cost of both planned capital expenditures and the expenses of daily operations and maintenance.

Newport News, on the other hand, separates the two operations and maintenance are included in our city's operating budget, while planned/budgeted capital improvements are completely separate.

The only tie-in of the two is in inclusion in the operating budget of the debt service requirement each year. And, the only marriage of the two occurs in the city's annual financial report which gives a complete picture of capital expenditures for the year—which is debt service—and all the operating and maintenance expenditures for the year.

Federal Government capital projects are expensed in their entirety in the year of acquisition or construction, which is completely opposite to that practiced by Newport News where only debt service is expensed.

Another difference between Newport News and the Federal Government is that Newport News does not borrow to finance current, on-going daily operations and maintenance expenditures. In effect, that policy would promote the payment of a city employee's salary or the cost of a pencil over a period of years while the debt was being repaid.

Operating deficits occur when current expenditures exceed current revenues. Even though a balanced budget has been approved,

a deficit can occur for a variety of reasons. A deficit in one year may not be cause for concern. However, frequent and increasing deficits are. Continuing the practice of using reserves or fund balances to fund current operations, using short-term or internal borrowing, selling assets, and accounting gimmickry—that is, postponing current obligations, accruing revenues from future years to make current revenues seem higher, extending the length of the fiscal year so that revenues in the added months can be counted as revenues for the current year, depreciation, loans, etc.—all may lead to continued operating deficits. These methods only disguise the problem and do nothing to solve the underlying problems.

The Federal Government does not appear to have a debt limitation, whereas Newport News does. The Federal Government's policy of debt management ensures that future generations will pay for those benefits derived from the borrowing by past and current generations, whereas Newport News does not. Capital spending can only occur if the project has a useful life of 15 years or more—in other words, if the debt incurred for that project will be paid off before the project loses its usefulness.

Now, could Newport News' method of capital budgeting work at the Federal level? In theory, yes. In practice, maybe. Newport News' capital budgeting process is simple, is clear, with policy to keep capital spending within limits available to the city, both self-imposed and State-imposed. The Federal Government has no apparent capital or operations and maintenance spending limits, self-imposed or otherwise. Capital spending should be financed by borrowing if current revenue streams cannot cover the cost, and paid for over the period of time that the asset continues to provide benefits. Operations and maintenance spending, on the other hand, should only be financed with revenues of a current period. The city has no choice—if the revenue isn't there, service levels must be, and are, adjusted.

The problems of annual budget deficits and an escalating National debt burden experienced by the Federal Government must sooner or later be addressed and curtailed. As Mayor of the City of Newport News, I will not pretend to tell you how this should be done. Before the concept of a capital budget could be utilized at the Federal level, I believe that more exhaustive study of the concept needs to be undertaken, particularly as it may relate to the myriad functions of a Federal budget which now exceeds $1 trillion annually.

The most problematic feature of capital budgeting at the Federal level, in my estimation, would be the problem of affixing guidelines and criteria by which to measure exactly what falls under the definition of capital expenditure. Unless a clear definition exists as to what exactly constitutes a capital investment, I fear that for all intents and purposes all expenditures currently in the Federal budget might be construed as investment. Without strict expenditure guidelines, not only might things such as equipment, infrastructure, ships, aircraft, buildings, etc., be classified as capital investment, but functions which enhance the quality of life such as social services and aid-to- education might eventually end up in this category as well.

Unless capital budgeting is defined clearly and guidelines are developed so as to put parameters around what is and what is not a capital investment, I do not see the benefits of implementing a capital budget at the Federal level. In Newport News, we have these guidelines in place and they work. Clearly, I do encourage you and your subcommittee to continue to examine the concept of a capital budget to see whether indeed it can be implemented or employed at the Federal level, particularly in light of the current budgetary chaos in Washington. It is essential that constructive and appropriate adjustments to the Congressional budget process be looked into.

I have given you an example of how capital budgeting works in the City of Newport News, and would be happy to answer any questions that you may have. Once again, I want to thank you very much for allowing me to appear before your subcommittee today, and I look forward to working with you in any way that I can and be of assistance as you continue to study this problem.

Mr. APPLEGATE. Thank you very much, Mayor Rattley. It's nice to have you here, and you gave very good testimony, too. I commend you for being the public servant that you are, serving as Mayor; that is certainly not easy. The problems are even greater than what we face, although many people look and say we have the toughest job in the world, but we are here and we print money, and you are there and you don't. And you have to incur, sometimes, the wrath of the people that you have to look at eyeball-to-eyeball everyday.

Did I hear you say that a capital budget, basically, should be accompanied by a revenue program?

Ms. RATTLEY. Yes.

Mr. APPLEGATE. Let me ask you this: you said that capital spending or debt services is used only for capital projects with a useful life of 15 or more years. Are there any capital projects that have less than a 15-year useful life; and, if so, are they expensed in the year of acquisition or construction, or is some other financial vehicle used?

Ms. RATTLEY. The standard that we set in Newport News is that the project must have a useful life of at least 15 years; if it doesn't, then it comes out of the general operating budget. The only thing that is expensed is the debt service of the money that we borrow to pay for the project. And that, of course, is amortized over the life of the bond.

Mr. APPLEGATE. I think that you put your finger on some of the major problems and issues that concern a Federal capital budget process. One particular problem would be defining or setting guidelines for what is a capital investment. It seems that economists and accountants, as was mentioned before, have different approaches about whether to classify aid-to-education and research and development, among other things, under a capital budget or an operating budget.

Let me ask you this: does Newport News carry social service functions and education under its operating budget and, if so, how is the determination made?

Ms. RATTLEY. Yes, all of those items go in to the operating budget along with salaries, expenditures for all of those items that would last less than 15 years. I'll use a common illustration of a pencil,

office supplies, they all come from the operating budget; including our schools, they come out of operating budgets; all monies paid to social services, all of that is in the operating budget. You could say it's an investment in humans, you know, it's a human investment. But we don't look at it as a capital investment. We talk about those things we can see and touch, those are capital expenditures; roads that we spend millions of dollars on—for roads—capital that we expect to last more than 15 years. We had an illustration in the City of Newport News; you think in terms of a roof on a building which used to be, a long time ago, you got a 20- to 25-year warranty; not any more. And we find ourselves replacing roofs every year. As soon as the warranty expires, the roof is in need of repair or replacement. So we have stopped putting that in the capital budget because it's not long enough.

In other words, we don't want to be paying on any project unless it is still usable, it is still in our stock. If we use it up, we feel as though it should be paid for from our general operating budget the year that we purchase it; it is not spread over several years.

We just approved our capital budget just a few weeks ago—two weeks ago, to be exact—which is altogether different from our general operating budget. We have public hearings on the capital budget, and I stayed in council last night until after midnight—I caught a plane out of Newport News early this morning—on one capital improvement project, that is, to build a new courthouse. But we had citizens there saying we don't want it and we want you to delay it. But this capital budget is an approved five-year capital expenditure, but we change it whenever there is a need or change in priority; and, then, that is amortized over the life of the bond—the money we borrowed in order to pay for that particular project. But this is paid up front in the general operating budget. Even though it may last five or ten years, it's already paid for; and, once we use it up, we replace it from the general operating budget. There are those items that you just use up and they are no more, they have no further value. But all of those that we expect to be usable for at least 15 years, they go in our capital improvement budget.

Mr. APPLEGATE. That's very interesting; and, I thank you very much for that answer.

Mr. Shaw?

Mr. SHAW. Mayor, I don't have any questions. I want to commend you on starting out your testimony by saying that you were not an accountant or a CPA, but I must say that you have a very thorough knowledge of what you speak, both in your prepared statement and in your answers to questions of the accounting system of the cities.

As a former mayor myself and as formerly on the Executive Committee of the U.S. Conference of Mayors, I can say that the Federal Government can learn an awful lot from the cities. I think you've certainly proven that with your testimony. I thank you for being here and sharing your experience with us.

I know the City of Fort Lauderdale, where I was mayor, did not have a capital budget when I was there. I had them prepare a balance sheet once for the city in order to try to make the determination of where we were headed, but we never incorporated capital

budgeting. As a matter of fact, I hadn't even heard the term at that particular point. But, obviously, the cities are making a lot of headway and I certainly appreciate your contribution.

Thank you.

Mr. APPLEGATE. Thank you very much again, Mayor Rattley, for appearing before the committee. We appreciate very much, your very excellent testimony. I, too, would commend you. Keep up your good work.

Ms. RATTLEY. Thank you.

[Ms. Rattley's prepared testimony follows:]

UNITED STATES CONFERENCE OF MAYORS

1620 EYE STREET, NORTHWEST
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TESTIMONY OF MAYOR JESSIE RATTLEY, NEWPORT NEWS, VIRGINIA

BEFORE THE HOUSE PUBLIC WORKS AND TRANSPORTATION COMMITTEE

SUBCOMMITTEE ON ECONOMIC DEVELOPMENT

DECEMBER 9, 1987

GOOD MORNING, MY NAME IS JESSIE RATTLEY AND I AM THE MAYOR OF NEWPORT NEWS, VIRGINIA AND HAVE SERVED ON THE CITY COUNCIL SINCE 1970. I AM TESTIFYING BEFORE THIS SUBCOMMITTEE TODAY ON BEHALF OF THE U.S. CONFERENCE OF MAYORS.

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO PARTICIPATE IN THIS HEARING ON CAPITAL BUDGETING. CLEARLY THE CONGRESSIONAL BUDGET PROCESS DESERVES CONSIDERABLE ATTENTION GIVEN THE RATHER PERILOUS NATURE OF THE LEGISLATIVE CALENDAR BEFORE CONGRESS TODAY. I CERTAINLY DO NOT INTEND TO OFFER RECOMMENDATIONS ON HOW THE CONGRESSIONAL BUDGET PROCESS MIGHT BE IMPROVED OF REFORMED. HOWEVER, I WILL ATTEMPT THROUGH MY TESTIMONY TODAY, TO BRING TO LIGHT SOME OF THE ASPECTS OF THE CAPITAL BUDGETING PROCESS UTILIZED BY MY CITY AND IN MANY CITIES ACROSS THE NATION.

THE FEDERAL GOVERNMENT DOES NOT HAVE A CAPITAL BUDGET SEPARATE AND DISTINCT FROM ITS OPERATING BUDGET. CAPITAL BUDGETING/SPENDING IS INCORPORATED WITHIN THE "REGULAR" DAY TO DAY EXPENDITURES AND CLOUDS THE TRUE COST OF BOTH PLANNED CAPITAL EXPENDITURES AND THE EXPENSES OF DAILY OPERATIONS AND MAINTENANCE. NEWPORT NEWS, ON THE OTHER HAND, SEPARATES THE TWO - DAY TO DAY EXPENDITURES (OPERATIONS AND MAINTENANCE) ARE INCLUDED IN THE CITY'S OPERATING BUDGET WHILE PLANNED/BUDGETED CAPITAL EXPENDITURES ARE COMPLETELY SEPARATE.

THE ONLY TIE-IN OF THE TWO IS THE INCLUSION IN THE OPERATING BUDGET OF THE DEBT SERVICE REQUIREMENTS EACH YEAR. AND, THE ONLY

MARRIAGE OF THE TWO OCCURS IN THE CITY'S ANNUAL FINANCIAL REPORT WHICH GIVES THE COMPLETE PICTURE OF CAPITAL EXPENDITURES FOR THE YEAR (WHICH IS DEBT SERVICE) AND ALL THE OPERATING AND MAINTENANCE EXPENDITURES FOR THE YEAR. FEDERAL GOVERNMENT CAPITAL PROJECTS ARE EXPENSED IN THEIR ENTIRETY IN THE YEAR OF ACQUISITION OR CONSTRUCTION WHICH IS COMPLETELY OPPOSITE TO THAT PRACTICED BY NEWPORT NEWS (WHERE ONLY DEBT SERVICE IS EXPENSED).

ANOTHER DIFFERENCE BETWEEN NEWPORT NEWS AND THE FEDERAL GOVERNMENT IS THAT NEWPORT NEWS DOES NOT BORROW TO FINANCE CURRENT, ON-GOING DAILY OPERATIONS AND MAINTENANCE EXPENDITURES. IN EFFECT, THAT POLICY WOULD PROMOTE THE PAYMENT OF A CITY EMPLOYEE'S SALARY OR THE COST OF A PENCIL OVER A PERIOD OF YEARS WHILE THE DEBT WAS BEING REPAID.

OPERATING DEFICITS OCCUR WHEN CURRENT EXPENDITURES EXCEED CURRENT REVENUES. EVEN THOUGH A BALANCED BUDGET HAS BEEN APPROVED, A DEFICIT CAN OCCUR FOR A VARIETY OF REASONS. A DEFICIT IN ONE YEAR MAY NOT BE CAUSE FOR CONCERN. HOWEVER, FREQUENT AND INCREASING DEFICITS ARE. CONTINUING THE PRACTICE OF USING RESERVES OR FUND BALANCES TO FUND CURRENT OPERATIONS, USING SHORT-TERM OR INTERNAL BORROWING, SELLING ASSETS, AND ACCOUNTING "GIMMICKRY" (POSTPONING CURRENT OBLIGATIONS, ACCRUING REVENUES FROM FUTURE YEARS TO MAKE CURRENT REVENUES SEEM HIGHER, EXTENDING THE LENGTH OF THE FISCAL YEAR SO THAT REVENUES IN THE ADDED MONTHS CAN BE COUNTED AS REVENUES FOR THE CURRENT YEAR, DEPRECIATION, LOANS, ETC.) ALL MAY LEAD TO CONTINUED OPERATING

DEFICITS. THESE METHODS ONLY DISGUISE THE PROBLEM AND DO NOTHING TO SOLVE THE UNDERLYING PROBLEMS.

THE FEDERAL GOVERNMENT DOES NOT APPEAR TO HAVE A DEBT LIMITATION WHEREAS NEWPORT NEWS DOES. THE FEDERAL GOVERNMENT'S POLICY OF DEBT MANAGEMENT ENSURES THAT FUTURE GENERATIONS WILL PAY FOR THOSE BENEFITS DERIVED FROM THE BORROWING BY PAST AND CURRENT GENERATIONS WHEREAS NEWPORT NEWS DOES NOT - CAPITAL SPENDING CAN ONLY OCCUR IF THE PROJECT HAS A USEFUL LIFE OF 15 YEARS OR MORE (IN OTHER WORDS, IF THE DEBT INCURRED FOR THAT PROJECT WILL BE PAID OFF BEFORE THE PROJECT LOSES ITS USEFULNESS).

COULD NEWPORT NEWS' METHOD OF CAPITAL BUDGETING WORK AT THE FEDERAL LEVEL? IN THEORY, YES. IN PRACTICE, MAYBE. NEWPORT NEWS' CAPITAL BUDGETING PROCESS IS SIMPLE, CLEAR, WITH POLICY TO KEEP CAPITAL SPENDING WITHIN LIMITS AVAILABLE TO THE CITY (BOTH SELF-IMPOSED AND STATE-IMPOSED). THE FEDERAL GOVERNMENT HAS NOT APPARENT CAPITAL (OR OPERATIONS AND MAINTENANCE) SPENDING LIMITS, SELF-IMPOSED OR OTHERWISE. CAPITAL SPENDING SHOULD BE FINANCED BY BORROWING (IF CURRENT REVENUE STREAMS CANNOT COVER THE COST) AND PAID FOR OVER THE PERIOD OF TIME THE ASSET CONTINUES TO PROVIDE BENEFITS. OPERATIONS AND MAINTENANCE SPENDING ON THE OTHER HAND, SHOULD ONLY BE FINANCED WITH REVENUES OF THE CURRENT PERIOD. THE CITY HAS NO CHOICE - IF THE REVENUE ISN'T THERE, SERVICE LEVELS MUST BE, AND ARE, ADJUSTED.

THE PROBLEMS OF ANNUAL BUDGET DEFICITS AND AN ESCALATING

NATIONAL DEBT BURDEN EXPERIENCED BY THE FEDERAL GOVERNMENT MUST SOONER OR LATER BE ADDRESSED AND CURTAILED. I, AS A MAYOR, WILL NOT PRETEND TO TELL YOU HOW THIS SHOULD BE DONE. BEFORE THE CONCEPT OF A CAPITAL BUDGET COULD BE UTILIZED AT THE FEDERAL LEVEL, I BELIEVE THAT MORE EXHAUSTIVE STUDY OF THE CONCEPT NEEDS TO BE UNDERTAKEN. PARTICULARLY AS IT MAY RELATE TO THE MYRIAD FUNCTIONS OF A FEDERAL BUDGET WHICH NOW EXCEEDS $1 TRILLION DOLLARS ANNUALLY. THE MOST PROBLEMATIC FEATURE OF CAPITAL BUDGETING AT THE FEDERAL LEVEL, IN MY ESTIMATION, WOULD BE THE PROBLEM OF AFFIXING GUIDELINES AND CRITERIA BY WHICH TO MEASURE EXACTLY WHAT FALLS UNDER THE DEFINITION OF A CAPITAL EXPENDITURE. UNLESS A CLEAR DEFINITION EXISTS AS TO WHAT EXACTLY CONSTITUTES A CAPITAL INVESTMENT, I FEAR THAT FOR ALL INTENTS AND PURPOSES ALL EXPENDITURES CURRENTLY IN THE FEDERAL BUDGET MIGHT BE CONSTRUED AS INVESTMENT. WITHOUT STRICT EXPENDITURE GUIDELINES, NOT ONLY MIGHT THINGS SUCH AS EQUIPMENT, INFRASTRUCTURE, SHIPS, AIRCRAFT, BUILDINGS, ETC., BE CLASSIFIED AS CAPITAL INVESTMENTS, BUT FUNCTIONS WHICH ENHANCE THE QUALITY OF LIFE SUCH AS SOCIAL SERVICES AND AID-TO-EDUCATION MIGHT EVENTUALLY END UP IN THIS CATEGORY AS WELL.

UNLESS CAPITAL BUDGETING IS DEFINED CLEARLY AND GUIDELINES ARE DEVELOPED SO AS TO PUT PARAMETERS AROUND WHAT IS AND WHAT IS NOT A CAPITAL INVESTMENT, I DO NOT SEE THE BENEFITS OF IMPLEMENTING CAPITAL BUDGET AT THE FEDERAL LEVEL. IN NEWPORT NEWS WE HAVE THESE AND THEY WORK. CLEARLY I DO ENCOURAGE YOU AND YOUR SUBCOMMITTEE TO CONTINUE TO EXAMINE THE CONCEPT OF A CAPITAL

BUDGET TO SEE WHETHER INDEED IT CAN BE EMPLOYED AT THE FEDERAL LEVEL GIVEN THE CURRENT BUDGETARY CHAOS IN WASHINGTON. IT IS ESSENTIAL THAT CONSTRUCTIVE AND APPROPRIATE ADJUSTMENTS TO THE CONGRESSIONAL BUDGET PROCESS BE LOOKED AT.

I HAVE GIVEN YOU AN EXAMPLE OF HOW CAPITAL BUDGET WORKS IN NEWPORT NEWS AND WOULD BE HAPPY TO ANSWER ANY QUESTIONS THAT YOU MAY HAVE. THANK YOU AGAIN FOR ALLOWING ME TO APPEAR BEFORE YOUR SUBCOMMITTEE TODAY, AND I LOOK FORWARD TO WORKING WITH YOU IN ANY WAY THAT I CAN BE OF ASSISTANCE.

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Mr. APPLEGATE. Our next witness will be Ms. Linda E. Hollis, AICP, speaking on behalf of the American Planning Association.

Ms. Hollis, welcome to the committee.

TESTIMONY OF LINDA HOLLIS, AICP, AMERICAN PLANNING ASSOCIATION

Ms. HOLLIS. Thank you very much, Mr. Chairman, and Members of the subcommittee.

I am a planner, not a CPA, and from that standpoint I think what I have to say will be a bit more focused than the previous three witnesses. On the other hand, it will be longer-term in the sense of our future orientation, and you'll see what I mean.

My name is Linda Hollis. I am the senior planner with the firm of Tischler and Associates, Inc. We provide fiscal, economic and planning consulting services to local governments throughout the U.S.

And, incidentally, I should mention that lately we've been doing a lot of work in the State of Florida because they have new State legislation mandating capital improvement programming on the part of local governments, so I feel sure Ft. Lauderdale would now have such an animal.

I am representing the American Planning Association here today as a member of APA's national board of directors and, specifically, as chair of a committee called The National State Policy Coordinating Committee. This is a committee of the board that is charged with oversight of our Association's policy development process.

I request that my full remarks be included in the record, Mr. Chairman.

Mr. APPLEGATE. Without objection; they will be entered.

Ms. HOLLIS. The reason that we have such an interest in capital budgeting is because our members—we have some 21,000 members throughout the U.S.—work with capital budgeting and capital programming every day on the job. Our members work in a variety of Federal, State and local government settings as well as in the private sector. And, when I say capital programming and capital budgeting—let me get to my definitions; I'm going to skip over the purposes of testimony, get to my definitions, and then go back—we make the distinction between a capital budget and a capital program. Both are composed of capital projects.

As defined commonly by State and local governments, a capital project is a major long-term investment for facilities, land, or equipment. Now, the term may be as long as 15 years but, as you will see and in my experience, the term can be shorter than that.

A capital budget is a list of these capital projects. A capital budget is approved by the local government along with its operating budget for the next fiscal year. The capital improvement program is five or six years of capital budgets. And, what the American Planning Association encourages Congress to consider, as you look at all the legislative proposals before you in this area, is not only having a Federal capital budget but, in addition, having a Federal capital improvement program for the $15 billion a year that the Federal Government spends directly on domestic investment.

So, the two things that the American Planning Association wants to say to you today are first, we want to share the benefits that our members and, particularly, State and local governments, find in a long-term capital programming process; and, secondly, to encourage you, based on that experience, to look at enhancing the Federal capital budgeting process.

It's been mentioned, and I don't need to go into much detail, that a vast majority of State governments in this country have a long-term capital budgeting process. In addition, a survey done by the American Public Works Association in 1980 found that over half of cities and counties have a long-term capital budgeting process. We believe that today, seven years later with developments like the Florida State law, the figure would be even higher.

The reason that this long-term capital budgeting and programming process is so common is because State and local governments find a number of benefits in the process. The benefits are both political and economic.

One benefit is that the process encourages greater coordination among agencies within Government, between levels of Government, and between the public and private sectors. This coordination can lead to opportunities to leverage public dollars and to form public private partnerships.

Another benefit of capital programming that State and local governments have found is the avoidance of crisis management with adequate lead time—perhaps what's needed is not a whole new sewer plant but a package plant, or not a whole new school building but a modular addition.

Another benefit is the avoidance of everything falling apart at the same time; for example, the disaster in New York with the bridge falling apart. Perhaps if there had been a Federal capital budget, and the locality responsible for that bridge could count on Federal money to repair the bridge, such things would not have to happen.

Last, on the State and local level, capital programming and budgeting can improve bond ratings, saving citizens and their governments millions in debt service.

The political benefits of the capital budgeting process—and I was concerned at the comment that economists oppose this process—the political benefits are that things are laid out on the table and consensus can be reached. The quality of politics can be improved because everyone knows what the alternatives are—both proponents and opponents can say their piece and hear the other side, and the best possible compromise can be arrived at.

So, I would say the American Planning Association is very concerned at the idea that the implementation of capital programming and budgeting would muddy the waters. We feel that it would, on the other hand, enable the process to be more rational. We would expect, therefore, that capital programming and budgeting on the Federal level would have the benefits of better coordination and better allocation of scarce resources.

Our modest proposal, in conclusion, regards $15 billion I referred to in direct Federal capital investments and the $25 billion in 1986 dollars in grants to state and local governments. What the American Planning Association would like to see you consider is that the

$15 billion in direct spending be programmed at the Federal level on an annual basis and for five to six years in the future. For the Federal grants to State and local governments, we would expect them to do their own programming; but we would like to see a Federal capital investment strategy. We would like to see this strategy informed by some expert advice such as being chaired by the Council of Economic Advisors. We would like to see the expert advice be from all the different levels of Government.

As to more specific implementation, in my written statement I talked about specific responsibilities for the Office of Management and Budget; but given what has been said today and the shortness of time, I don't really think it's appropriate for me to go into that at this point.

Mr. Chairman, Members of the subcommittee, as you all know, the only solution to our infrastructure problems is going to involve more and better planning. And for that reason we really appreciate the opportunity to be here, and we look forward to working with you in the future.

Thank you.

Mr. APPLEGATE. Thank you very much, Ms. Hollis. And I agree with your last statement—we are going to have to have much better planning if we are going to address the infrastructure needs of local and State governments, because it is rapidly becoming one of the biggest problems, if not the biggest problem, that we have in the country today.

You've spoken about the prevalence of capital budgeting and capital improvement programming at the State and local levels of government to bring about a more rational and more effective approach to decision-making, as we just talked about on infrastructure improvements. And, I think that what you said was that about 70 percent of the States have some type of a long-range capital planning process, and that over half of the cities and the counties in the nation have multi year capital improvement programs. With this, is there any evidence that this type of capital budget planning has resulted in an overemphasis on capital budgets versus the operating budgets by either the State or local governments? In other words, is there truth to the charge that social and domestic programs are being hurt by this, or would be?

Ms. HOLLIS. No; I've been doing the type of consulting I'm doing now for about four years, and the most damage to the kind of social spending you're talking about has been in the cuts in general revenue sharing, CDBG, and other forms of Federal aid, as far as I can tell. So, on the one hand that is how I would answer your question.

Secondly, local government capital spending is generally on essential items on facilities which have to be provided. So, that's the best answer I can give you—I don't think so; I don't think it overemphasizes the capital. I think it's just essential that we rationalize the budget process and get the most detailed information possible.

So, I certainly agree with the gentleman from New York that you need more detailed information with which to make your decisions. And this is a step in that process.

Mr. APPLEGATE. Well, I think your testimony is very excellent and I would commend you for coming before the committee and bringing your knowledge and expertise to us, because it is very important. We will, of course, be hearing a lot about this over a long period of time before we, perhaps, can make a determination about any programs or directions toward improvements. It's very important and, as we stated before, we have a great number of problems that are facing in this country in our budgetary systems and in our accounting procedures in dealing with capital budgets as opposed to operating budgets. And we hope to see those resolved.

Mr. Shaw?

Mr. SHAW. Thank you, Mr. Chairman. I would like to echo your remarks and our appreciation for this witness being with us.

I have just one question. What do the cities do with Federal contributions or Federal grants, for capital, construction such as a sewage treatment plant that is built with monies contributed by EPA; do they capitalize that or would that contribution ever make it onto the books?

Ms. HOLLIS. Yes; water and sewer are generally enterprise funds; as you know, they are separate from the general fund. I have not done the level of scrutiny of enterprise funds as I have with general fund monies, but I'm almost positive that they have to report it; and how they would show the revenues, I'm not sure.

Mr. SHAW. The reason I asked that is I've been concerned for some time that Federal contributions don't make it into the rate structure and it's viewed as free money, and I have felt for a long time that municipalities or whatever district it is that's administering these facilities should be required to, at least, amortize Federal contributions, put it in the rate structure, and then put it in a separate fund that could then be used for obsolescence and what not.

The Clean Water Act and various other Acts of the Federal Government which created the availabilities of these funds for State and local government was originally considered as an investment to clean up the nation's waters. Now, it's developed into something that is generally expected by the local municipalities or municipal entities as the need grows to expand these facilities, replace these facilities, or even to cure obsolescence within these facilities; which, of course, was not the original intention of the Federal Government.

Do you have any thoughts on that?

Ms. HOLLIS. As I sit here listening to you, and I hadn't ever considered what you're saying before, but here I sit representing State and local government planners encouraging the Federal Government to be more accountable; I certainly think you would be entitled to require the recipients of grants to be accountable to you likewise.

Mr. SHAW. Thank you. Thank you for your testimony.

Mr. APPLEGATE. We have had—not yet, Ms. Hollis; we are going to still subject you to some testimony.

Ms. HOLLIS. No problem; I was just worried about your time.

Mr. APPLEGATE. You've got the toughest one coming yet.

Ms. HOLLIS. I was worried about your time here.

Mr. APPLEGATE. We're in good shape yet. They haven't rung for us.

But, Helen Bentley has come to the committee. She is a Member of the committee. Helen, do you have something that you would like to ask the witness?

Ms. BENTLEY. Not really.

I apologize, I wasn't able to hear you but I have thumbed through your testimony and I will read it very carefully, because this is a subject in which I am very interested. And, I echo what the Chairman said about the importance of proper program planning for our infrastructure replacement in this country, so I will look at all of this very carefully.

Thank you for your presentation.

Ms. HOLLIS. Thank you.

Mr. APPLEGATE. Thank you very much, Ms. Hollis, for appearing before the committee.

Ms. HOLLIS. Now I can go?

Mr. APPLEGATE. Now you can go.

Ms. HOLLIS. Thank you.

[Ms. Hollis' prepared statement follows:]

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STATEMENT OF

LINDA E. HOLLIS, AICP

on behalf of the

AMERICAN PLANNING ASSOCIATION

BEFORE A HEARING OF THE

SUBCOMMITTEE ON ECONOMIC DEVELOPMENT

HOUSE COMMITTEE ON PUBLIC WORKS AND TRANSPORTATION

on

CAPITAL IMPROVEMENTS PROGRAMMING AND BUDGETING:
LOCAL, STATE AND FEDERAL

December 9, 1987

MR. CHAIRMAN AND MEMBERS OF THE HOUSE SUBCOMMITTEE ON ECONOMIC DEVELOPMENT:

MY NAME IS LINDA HOLLIS. I AM THE SENIOR PLANNER WITH THE FIRM OF TISCHLER & ASSOCIATES, INC. WE PROVIDE FISCAL, ECONOMIC AND PLANNING CONSULTING SERVICES TO LOCAL GOVERNMENTS THROUGHOUT THE U.S. IN THAT CAPACITY I HAVE WORKED ON CAPITAL IMPROVEMENT PROGRAMS IN JURISDICTIONS AS VARIED AS PLYMOUTH, MINNESOTA, HILLSBOROUGH COUNTY AND VENICE, FLORIDA, AND NAGS HEAD, NORTH CAROLINA.

I AM ALSO A MEMBER OF THE BOARD OF DIRECTORS OF THE AMERICAN PLANNING ASSOCIATION. IN THAT CAPACITY I CHAIR THE NATIONAL/STATE POLICY COORDINATING COMMITTEE. THIS COMMITTEE OVERSEES THE ORGANIZATION'S POLICY DEVELOPMENT AND IMPLEMENTATION PROCESS. IT IS IN MY ROLE AS CHAIR OF THE POLICY COMMITTEE THAT I REPRESENT THE ASSOCIATION TODAY.

I RESPECTFULLY REQUEST THAT THE COMPLETE TEXT OF MY PREPARED STATEMENT BE INCLUDED IN THE HEARING RECORD.

THE AMERICAN PLANNING ASSOCIATION IS A NATIONAL ORGANIZATION OF 21,000 MEMBERS, INCLUDING PUBLIC AND PRIVATE PLANNERS AND ELECTED AND APPOINTED OFFICIALS AT ALL LEVELS OF GOVERNMENT, AS WELL AS EDUCATORS, STUDENTS AND INTERESTED CITIZENS. OUR MEMBERS BELONG TO 45 CHAPTERS COVERING EVERY STATE AND CONGRESSIONAL DISTRICT.

APA WAS FORMED IN 1978 WHEN THE AMERICAN INSTITUTE OF PLANNERS, ESTABLISHED IN 1917, AND THE AMERICAN SOCIETY OF PLANNING OFFICIALS, FOUNDED IN 1934, WERE CONSOLIDATED. THE ASSOCIATION'S PRIMARY OBJECTIVE IS TO ADVANCE THE ART AND SCIENCE OF PLANNING FOR THE IMPROVED DEVELOPMENT OF THE NATION AND ITS COMMUNITIES, STATES AND REGIONS, AS WELL AS THE CONSERVATION OF ITS RESOURCES. WITHIN APA IS THE AMERICAN INSTITUTE OF CERTIFIED PLANNERS (AICP) WHICH FOCUSES ON PROFESSIONAL DEVELOPMENT. MEMBERS OF AICP ARE DISTINGUISHED BY HAVING MET EXPERIENCE REQUIREMENTS AND HAVING PASSED AN EXAMINATION ON PLANNING PRINCIPLES AND PRACTICES.

THE AMERICAN PLANNING ASSOCIATION HAS A MAJOR INTEREST IN CAPITAL IMPROVEMENT PROGRAMMING AND BUDGETING. MANY OF THE ASSOCIATION'S 21,000 MEMBERS -- PROFESSIONAL STAFF OF MUNICIPAL AND COUNTY PLANNING OFFICES, MEMBERS OF PLANNING COMMISSIONS, CITY COUNCILS AND OTHER PUBLIC BODIES CONCERNED WITH PLANNING -- ARE DIRECTLY INVOLVED IN CAPITAL IMPROVEMENT PROGRAMMING AND CAPITAL BUDGETING. OUR MEMBERSHIP ALSO INCLUDES STAFF FOR REGIONAL AGENCIES SUCH AS WATER UTILITIES AND SEWER DISTRICTS AND FOR STATE AGENCIES SUCH AS OFFICES OF PLANNING AND BUDGET, DEPARTMENTS OF TRANSPORTATION, AND ENVIRONMENTAL PROTECTION AGENCIES. FINALLY, WE HAVE MEMBERS WORKING IN A VARIETY OF SETTINGS AT THE FEDERAL LEVEL. WHEREVER THEY WORK, SOME OF THE CENTRAL FUNCTIONS OF THE PLANNING OFFICIAL AND THE PROFESSIONAL PLANNER ARE TO ASSESS THE CURRENT CONDITIONS OF PUBLIC FACILITIES FOR MEETING LONG-TERM NEEDS; TO ANALYZE THE COSTS AND BENEFITS OF

VARIOUS ALTERNATIVES FOR MEETING ANY IDENTIFIED NEEDS; AND TO MAKE RECOMMENDATIONS TO ELECTED OFFICIALS ON HOW NEEDED CAPITAL INVESTMENTS SHOULD BE SCHEDULED AND FINANCED.

PURPOSES OF TESTIMONY

I HAVE TWO PURPOSES IN TESTIFYING TODAY.

THE FIRST IS TO SHARE WITH THE SUBCOMMITTEE THE BENEFITS THAT MANY STATE AND LOCAL GOVERNMENTS DERIVE FROM THE USE OF CAPITAL IMPROVEMENT PROGRAMMING AND BUDGETING.

MY SECOND PURPOSE IS TO PRESENT OUR REASONS AS TO WHY THE FEDERAL CAPITAL PROGRAMMING AND BUDGETING PROCESS SHOULD BE ENHANCED. THESE REASONS ARE BASED ON OUR MEMBERS' EXPERIENCES AT ALL LEVELS OF GOVERNMENT.

DEFINITIONS

I SHALL BEGIN WITH THREE DEFINITIONS. WHAT IS A CAPITAL IMPROVEMENT PROJECT, A CAPITAL BUDGET, AND A CAPITAL IMPROVEMENT PROGRAM?

A CAPITAL IMPROVEMENT PROJECT, AS DEFINED BY STATE AND LOCAL GOVERNMENTS, IS ANY MAJOR, LONG TERM INVESTMENT FOR FACILITIES, LAND OR EQUIPMENT. THE DEFINITIONS OF "ACQUISITION,"

"CONSTRUCTION," "PUBLIC WORKS IMPROVEMENTS" AND "REHABILITATION" IN THE FEDERAL PUBLIC WORKS IMPROVEMENT ACT OF 1984 WOULD BE CONSIDERED CAPITAL PROJECTS. HOWEVER, APA WOULD GO A STEP FURTHER AND RECOMMEND INCLUDING IN THE DEFINITION OF A CAPITAL PROJECT, THE COSTS OF DETAILED PLANNING, ENGINEERING AND ARCHITECTURAL STUDIES CONDUCTED BEFORE CONSTRUCTION. THESE NON-CONSTRUCTION COSTS CAN AMOUNT TO 6 TO 15 PERCENT OF TOTAL PROJECT COSTS, AND BUDGETING FOR THEM OFTEN IMPLIES A DE FACTO COMMITMENT TO THE PROJECT. THEREFORE, IT IS IMPORTANT TO RECOGNIZE THEM.

A CAPITAL BUDGET IS THE PRIORITIZED LIST OF CAPITAL IMPROVEMENT PROJECTS, ADOPTED BY THE GOVERNING BODY ALONG WITH THE OPERATING BUDGET FOR THE NEXT FISCAL YEAR. IT INCLUDES PROJECTS FINANCED BY VARIOUS REVENUE SOURCES.

A CAPITAL IMPROVEMENT PROGRAM (CIP) IS A LONGER TERM PLAN OR SCHEDULE OF IMPROVEMENTS, USUALLY FOR FIVE OR SIX YEARS. A CIP IS NOT LEGALLY BINDING, AND--EXCEPT FOR THOSE PROJECTS IN THE CIP SCHEDULED FOR THE NEXT FISCAL YEAR--DOES NOT COMMIT THE GOVERNING BODY TO A PARTICULAR EXPENDITURE IN A PARTICULAR YEAR. IT DOES, HOWEVER, PROVIDE A GENERAL ORIENTATION TO CAPITAL PROJECT PRIORITIES AT A GIVEN POINT IN TIME AND ALSO IDENTIFIES THE SEQUENCE OF EVENTS THAT IS NECESSARY (E.G., FEASIBILITY STUDIES, PRELIMINARY ENGINEERING, DETAILED ENGINEERING, AND CONSTRUCTION) FOR PROJECTS TO BE BUILT.

HAVING DEFINED THESE TERMS, WE WILL NOW COMMENT ON THE FREQUENCY OF THEIR EXISTENCE.

PREVALENCE AT STATE AND LOCAL LEVELS

CAPITAL BUDGETING AND CAPITAL IMPROVEMENT PROGRAMMING ARE RELATIVELY COMMON AMONG STATE AND LOCAL GOVERNMENTS. RECENT SURVEYS BY THE FEDERAL OFFICE OF MANAGEMENT AND BUDGET AND BY THE NATIONAL CONFERENCE OF STATE LEGISLATURES FOUND THAT OVER 70% OF STATES HAVE SOME TYPE OF LONG RANGE CAPITAL BUDGETING PROCESS.

ON THE LOCAL LEVEL, IN 1980 OVER HALF OF THE CITIES AND COUNTIES NATIONWIDE WERE ESTIMATED TO HAVE MULTI-YEAR CAPITAL IMPROVEMENT PROGRAMS BY THE AMERICAN PUBLIC WORKS ASSOCIATION. THESE FIGURES ARE PROBABLY HIGHER NOW.

NOT ALL OF THESE BUDGETING PROCESSES ARE ALIKE, NOR DO THEY HAVE TO BE. BUT THEIR PREVALENCE REFLECTS A DETERMINATION ON THE PART OF STATE AND LOCAL GOVERNMENTS AND OF THEIR CITIZENS TO BRING ABOUT A MORE RATIONAL AND EFFECTIVE APPROACH TO DECISION-MAKING ON INFRASTRUCTURE IMPROVEMENTS.

BENEFITS OF CIPs

THE PREVALENCE OF CIPs AT THE STATE AND LOCAL LEVELS REFLECTS THE BENEFITS THAT THESE GOVERNMENTS AND THEIR CITIZENS HAVE DERIVED

FROM THEIR USE. THESE BENEFITS ARE OF AN ECONOMIC AS WELL AS A POLITICAL NATURE. HERE ARE FIVE ECONOMIC BENEFITS:

1) BY PLANNING AHEAD, STATE AND LOCAL GOVERNMENTS CAN COORDINATE AMONG FUNCTIONAL AREAS WITHIN THEIR OWN DEPARTMENTS, WITH PRIVATE DEVELOPERS, AND WITH OTHER LEVELS OF GOVERNMENT. SUCH COORDINATION CAN ENSURE, FOR EXAMPLE, THAT STREETS AND HIGHWAYS ONLY HAVE TO BE DUG UP ONCE FOR THE INSTALLATION OF NEW SEWER, WATER, GAS, AND CABLE TELEVISION LINES, NOT FOUR TIMES. THIS SAVES EVERYONE TIME AND MONEY AND REDUCES INCONVENIENCE.

2) BY SHARING AND COORDINATING THEIR PLANS FOR CAPITAL IMPROVEMENTS WITH THE PRIVATE SECTOR, STATE AND LOCAL GOVERNMENTS CAN CREATE OPPORTUNITIES TO LEVERAGE PUBLIC DOLLARS, AND TO FOSTER ECONOMIC DEVELOPMENT.

3) BY PLANNING AHEAD, COSTLY CRISIS MANAGEMENT CAN BE AVOIDED. WITH PLANNING AND LEAD TIME, STATE AND LOCAL GOVERNMENTS HAVE THE OPTION OF ASKING WHETHER A FACILITY IS REALLY NEEDED, AND TO ASSESS OTHER, PERHAPS MORE COST-EFFECTIVE, ALTERNATIVES.

4) CAPITAL PROGRAMMING AND BUDGETING ALSO PROVIDES AN OPPORTUNITY TO AVOID FINANCIAL DISASTERS, WITH EVERYTHING FALLING APART AT THE SAME TIME. BY PLANNING AHEAD, PROJECTS CAN BE SCHEDULED OVER TIME AND NEW SOURCES OF FUNDING EXPLORED.

5) CAPITAL PROGRAMMING AND BUDGETING CAN HELP STATE AND LOCAL GOVERNMENTS TO DEMONSTRATE TO THE BOND RATING AGENCIES THAT THEY ARE MANAGING THEIR CAPITAL ASSETS WITH CARE. BOND RATINGS CAN BE IMPROVED, SAVING THESE GOVERNMENTS AND THEIR CITIZENS CONSIDERABLE MONEY IN DEBT SERVICE.

THERE ARE TWO SIGNIFICANT POLITICAL BENEFITS OF CIPs:

1) THE MOST OBVIOUS BENEFIT OF CAPITAL PROGRAMMING AND BUDGETING PROCESSES IS THE EXCEPTIONAL DEGREE OF CONSENSUS ON THE FINAL BUDGET THAT CAN RESULT. CITIZENS ARE PLEASED WITH A PROCESS THAT GIVES THEM THE OPPORTUNITY TO REVIEW AND QUESTION THE RECOMMENDATIONS OF STAFF, AS WELL AS TO PUT FORWARD PROJECTS OF THEIR OWN. ELECTED OFFICIALS ARE PARTICULARLY PLEASED WITH THE PROCESS BECAUSE THE DECISIONS ARE BOTH RATIONAL, ECONOMICAL, AND PUBLICLY SUPPORTED. THIS MAKES THE JOB EASIER FOR ELECTED OFFICIALS, WHO ARE OFTEN CAUGHT BETWEEN TECHNICAL ARGUMENTS ON THE ONE HAND AND THE PUBLIC'S WISHES ON THE OTHER.

2) FINALLY, THE CAPITAL PROGRAMMING AND BUDGETING PROCESS CAN IMPROVE THE QUALITY OF POLITICS. MAKING DECISIONS ON CAPITAL INVESTMENTS IS NOT A SCIENTIFICALLY RATIONAL PROCESS. SUCH DECISION-MAKING IS THE VERY ESSENCE OF POLITICS, IN THE BEST SENSE OF THE WORD. THE QUESTION IS HOW TO ALLOCATE VERY SCARCE RESOURCES AMONG COMPETING DEMANDS. CONFLICTS ARISE IN THIS PROCESS BECAUSE DIFFERENT INDIVIDUALS AND DIFFERENT GROUPS PLACE

DIFFERENT VALUES ON VARIOUS OPTIONS. A GOOD CAPITAL PROGRAMMING PROCESS IN A STATE OR A LOCAL COMMUNITY, HOWEVER, CAN PROVIDE A SETTING IN WHICH TO MANAGE THESE INEVITABLE CONFLICTS. THIS IS DONE BY INVOLVING EVERYONE IN THE PROCESS, MAKING AVAILABLE ADEQUATE INFORMATION AND THE OPPORTUNITY TO EXPRESS ONE'S VIEWS AND TO HEAR THE VIEWS OF OTHERS. CAPITAL PROGRAMMING CREATES AN OPPORTUNITY TO ORGANIZE AND MAKE THOUGHTFUL THE DIFFICULT POLITICAL PROCESS OF CHOOSING AMONG OPTIONS FOR SPENDING LIMITED DOLLARS.

CAPITAL PROGRAMMING AND BUDGETING ON THE FEDERAL LEVEL

AS ON THE STATE AND LOCAL LEVELS, CAPITAL PROGRAMMING AND BUDGETING ON THE FEDERAL LEVEL WILL HAVE THE FOLLOWING BENEFITS:

1) BETTER COORDINATION AMONG AGENCIES, WITH THE PRIVATE SECTOR, AND WITH OTHER LEVELS OF GOVERNMENT. FOR EXAMPLE, DIFFERENT AGENCIES MAY BE ABLE TO SHARE FACILITIES, SUCH AS A POST OFFICE ALSO HOUSING A FARMERS HOME ADMINISTRATION OFFICE. ANOTHER EXAMPLE IS THE DECISION TO EXPAND A MILITARY BASE AND ITS IMPACTS ON LOCAL GOVERNMENT. IF NOTIFIED FIVE OR SIX YEARS IN ADVANCE, LOCAL PLANNERS COULD MAKE PROVISIONS FOR EXPECTED INCREASES IN TRAFFIC AND OTHER DEMANDS ON PUBLIC FACILITIES RESULTING FROM THE MILITARY BASE EXPANSION.

2) BETTER ALLOCATION OF SCARCE RESOURCES. WE BELIEVE THAT CAPITAL PROGRAMMING AND BUDGETING WILL ALLOW THE FEDERAL GOVERNMENT TO SPEND MONEY WISELY, NOT SAVE MONEY FOOLISHLY. THE PROCESS WILL GIVE MEMBERS OF CONGRESS AN OVERVIEW OF FEDERAL CAPITAL INVESTMENTS AND A MUCH CLEARER SENSE ABOUT HOW TO TARGET FEDERAL SPENDING TO HELP MEET NATIONAL OBJECTIVES. IT WILL BUILD CONSENSUS FOR THE FINAL BUDGET DOCUMENT ADOPTED BY CONGRESS BECAUSE INTERESTED PARTIES WILL HAVE AN OPPORTUNITY TO INFLUENCE THE PROCESS AND WILL BE MORE ABLE TO UNDERSTAND WHY CERTAIN BUDGETING DECISIONS WERE MADE. INDIVIDUAL FEDERAL DEPARTMENTS AND BUREAUS WILL HAVE AN OPPORTUNITY TO EXPLAIN AND ADVOCATE THEIR PERSPECTIVES. PROPONENTS AND OPPONENTS CAN SUPPORT OR QUESTION ALTERNATIVE CAPITAL INVESTMENT STRATEGIES.

THERE ARE TWO MAIN TYPES OF FEDERAL CAPITAL INVESTMENT. THE FIRST TYPE IS DIRECT FEDERAL SPENDING ON CAPITAL PROJECTS, ESTIMATED AT $14 BILLION PER YEAR. THE SECOND TYPE IS FEDERAL GRANTS TO STATE AND LOCAL GOVERNMENTS, ESTIMATED AT $25 BILLION PER YEAR. BOTH TYPES OF SPENDING ARE IMPORTANT, AND BOTH COULD BENEFIT FROM BETTER PLANNING. DIFFERENT APPROACHES ARE APPROPRIATE FOR EACH. FOR DIRECT FEDERAL SPENDING, WE RECOMMEND A SIX YEAR CAPITAL IMPROVEMENT PROGRAM. FOR FEDERAL GRANTS, WE RECOMMEND A BROADER CAPITAL INVESTMENT STRATEGY. EACH APPROACH WILL BE DESCRIBED IN TURN BELOW.

FEDERAL CAPITAL PROJECTS INCLUDE SUCH ITEMS AS WEAPONS SYSTEMS, MILITARY BASES, ROADS AND BRIDGES, AIRPORTS, MASS TRANSIT, WATER AND WASTEWATER SYSTEMS, HOSPITALS, RAILROADS, HOUSING, AND PUBLIC BUILDINGS. FOR THESE EXPENDITURES WE RECOMMEND THAT THE OFFICE OF MANAGEMENT AND BUDGET HAVE RESPONSIBILITY FOR THE ANNUAL CAPITAL BUDGET AND THE SIX YEAR CAPITAL IMPROVEMENT PROGRAM. THESE RESPONSIBILITIES WOULD INCLUDE:

1) DEVELOPING STANDARD PROCEDURES BY WHICH FEDERAL AGENCIES WOULD SUBMIT PROJECTS FOR THE CAPITAL BUDGET AND THE LONGER TERM CAPITAL IMPROVEMENT PROGRAM. THESE PROCEDURES WOULD, IN PART, INVOLVE RESPONDING TO QUESTIONS ON RELATIVE NEED AND PRIORITY, ALTERNATIVES CONSIDERED, STATUS OF PLANS (E.G., IS THE PROJECT READY TO GO?), AND BENEFIT/COST ANALYSIS.

2) DEVELOPING RANKING CRITERIA AND PRIORITIES FOR PROJECTS THROUGH A RULE-MAKING PROCESS, BASED ON GENERAL CONGRESSIONAL GUIDELINES IN FEDERAL STATUTES.

3) SETTING A CAP ON SPENDING FOR CAPITAL INVESTMENTS, AND PROJECTING THAT CAP OVER THE LIFE OF THE CAPITAL IMPROVEMENT PROGRAM. A RULE OF THUMB IN LOCAL GOVERNMENT IS THAT FROM 8 TO 10 PERCENT OF OPERATING OR CURRENT EXPENSES SHOULD GO FOR CAPITAL PROJECTS.

4) PRODUCING, ON BEHALF OF THE ADMINISTRATION, THE CAPITAL BUDGET AND CAPITAL IMPROVEMENT PROGRAM DOCUMENT FOR SUBMISSION TO CONGRESS. THE DOCUMENT WOULD CATEGORIZE FEDERAL CAPITAL INVESTMENTS BY TYPE (E.G., MILITARY OR CIVILIAN, HOUSING, PARK ACQUISITION AND DEVELOPMENT) AND WOULD SET INVESTMENT PRIORITIES WITHIN THE VARIOUS FUNDING CATEGORIES, CONSISTENT WITH OVERALL SPENDING LIMITS.

5) TRACKING PROJECTS ONCE CONGRESS HAS APPROVED THEM AND REPORTING ON THE IMPLEMENTATION OF THE CAPITAL BUDGET AND CAPITAL IMPROVEMENT PROGRAM. THIS REPORT WOULD BE PART OF THE ANNUAL BUDGET PROCESS.

IN THE CASE OF FEDERAL GRANTS, WE EXPECT ANY CAPITAL FACILITIES THEY FUND TO BE PROGRAMMED AT THE STATE OR LOCAL LEVEL. THE DECISIONS TO BE MADE AT THE NATIONAL LEVEL ARE WHERE TO ALLOCATE SCARCE RESOURCES -- ON WHAT TYPES OF FACILITIES. THESE DECISIONS SHOULD BE INFORMED BY AN OVERALL FEDERAL CAPITAL INVESTMENT STRATEGY.

SUCH A STRATEGY WOULD BEGIN TO LINK TOGETHER INDIVIDUAL PROGRAMS, RELATING THEM TO IMPORTANT GOALS SUCH AS ECONOMIC DEVELOPMENT, FISCAL SOUNDNESS, AND NATIONAL SECURITY. WE RECOMMEND THAT SUCH A STRATEGY BE FORMULATED WITH THE ADVICE OF AN ANNUAL CONCLAVE, CONVENED BY A GROUP LIKE THE COUNCIL OF ECONOMIC ADVISERS. THE

CONCLAVE WOULD BE COMPOSED OF FEDERAL, STATE AND LOCAL OFFICIALS, CONGRESSIONAL LEADERS, AND APPROPRIATE CABINET MEMBERS.

THERE ARE GOOD PRECEDENTS FOR THIS APPROACH AT THE STATE AND LOCAL LEVELS. FOR EXAMPLE, ST. PAUL, MINNESOTA, HAS ESTABLISHED A "CAPITAL ALLOCATION POLICY." THIS IS A SET OF STATEMENTS GUIDING HOW THE CITY SHOULD ALLOCATE ITS CAPITAL FUNDS. IT IS PREPARED EVERY TWO YEARS BY THE CITY'S PLANNING COMMISSION WITH INPUT FROM CITIZENS AND STAFF, AND ADOPTED BY THE CITY COUNCIL. THE POLICIES ARE QUITE COMPREHENSIVE, ADDRESSING ISSUES SUCH AS OVERALL DEBT LIMITATIONS, GUIDELINES FOR THE USE OF VARIOUS TYPES OF FUNDS, IDENTIFICATION OF PRIORITY AREAS FOR INVESTMENT, MINIMUM OR NECESSARY REQUIREMENTS FOR INDIVIDUAL PROJECTS (E.G., RETURN ON INVESTMENT), AND EVEN CLEAR PROHIBITIONS ON SOME TYPES OF PROJECTS. THE CAPITAL ALLOCATION POLICY IS THE UNDERPINNING FOR THE FIVE-YEAR CAPITAL IMPROVEMENT PROGRAM AND THE CITY'S ANNUAL CAPITAL BUDGET.

APA'S RECOMMENDATIONS

WE RECOMMEND THAT A FEDERAL CAPITAL INVESTMENT STRATEGY, SIMILAR TO ST. PAUL'S CAPITAL ALLOCATION POLICY, BE DEVELOPED AS PART OF THE ANNUAL BUDGET PROCESS. IN ADDITION TO THIS STRATEGY FOR ALLOCATING FEDERAL GRANTS, WE RECOMMEND THE FORMULATION OF AN ANNUAL CAPITAL BUDGET AND A SIX YEAR CAPITAL IMPROVEMENT PROGRAM FOR DIRECT FEDERAL SPENDING ON CAPITAL FACILITIES.

AS YOU KNOW, MR. CHAIRMAN, IN 1984 THE HOUSE PUBLIC WORKS AND TRANSPORTATION COMMITTEE ORIGINATED A BILL WHICH BECAME TITLE II OF PUBLIC LAW 98-501, THE FEDERAL CAPITAL INVESTMENT PROGRAM INFORMATION ACT OF 1984. WE SUPPORTED THIS BILL AND TESTIFIED ON ITS BEHALF. PURSUANT TO THIS LEGISLATION, THE OFFICE OF MANAGEMENT AND BUDGET NOW PUBLISHES THE SUPPLEMENT TO SPECIAL ANALYSIS D. WE BELIEVE THIS IS A CONSTRUCTIVE FIRST STEP AND A SOUND FOUNDATION UPON WHICH OUR RECOMMENDATIONS CAN BUILD.

WE NOW URGE CONGRESS TO FAVORABLY CONSIDER LEGISLATION ESTABLISHING A CAPITAL IMPROVEMENT PROGRAM FOR FEDERAL PROJECTS AND A CAPITAL INVESTMENT STRATEGY FOR FEDERAL GRANTS. THE STRATEGY SHOULD BE INFORMED BY AN INTERGOVERNMENTAL ADVISORY PROCESS. THIS LEGISLATION COULD BE IN THE FORM OF AMENDMENTS TO TITLE II OF PUBLIC LAW 98-501.

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE, IN THE FINAL ANALYSIS, THE SOLUTION TO THE INFRASTRUCTURE CRISIS MUST INVOLVE PLANNING. THE FEDERAL, STATE AND LOCAL GOVERNMENTS MUST JUDGE WHICH FACILITIES ARE MOST CRITICAL TO THEIR GOALS; WHEN THEY SHOULD REPAIR OR REHABILITATE AS OPPOSED TO REPLACE FACILITIES; AND WHAT LEVEL OF SERVICES OR QUALITY OF FACILITIES TRULY REFLECTS CITIZENS' DESIRES AND WILLINGNESS TO PAY.

THANK YOU FOR THE OPPORTUNITY TO EXPRESS THE VIEWS OF THE AMERICAN PLANNING ASSOCIATION. WE WOULD BE DELIGHTED TO ASSIST THE SUBCOMMITTEE IN THIS IMPORTANT MATTER AND TO RESPOND TO YOUR QUESTIONS.

Mr. APPLEGATE. I have a statement of the National Conference of State Legislatures that shall, without objection be inserted in the record.

[The material referred to follows:]

Statement of

THE NATIONAL CONFERENCE OF STATE LEGISLATURES

submitted to the

Subcommittee on Economic Development

Committee on Public Works and Transportation

U. S. House of Representatives

on

"CAPITAL BUDGETING IN THE STATES"

December 9, 1987

In March 1985, the National Conference of State Legislatures formed the Capital Budgeting and Finance Subcommittee. This Subcommittee was charged with developing recommendations for strengthening legislative oversight of the state capital budgeting and finance process.

The work of this Subcommittee has resulted in a report entitled; "Capital Budgeting and Finance: The Legislative Role." The role of the legislature in financing capital investment is critical to any consideration of a national infrastructure policy. States and local governments are presently financing some two-thirds of infrastructure costs. I would urge this Subcommittee's recognition of both state capabilities and state limitations to take on additional responsibilities.

Hopefully, the members of this Subcommittee will benefit from the state experience in capital budgeting. The report presents some 16 recommendations for improving the decision-making process involved with state infrastructure finance. In so doing, those states which have taken the lead in thoughtful and innovative approaches are identified.

The first recommendation made in the Committee's report is for more focus to be placed on capital budgeting by state governments. The reason for this is threefold: federal infrastructure assistance is declining; deficiencies in aging facilities demand attention; and the capital finance environment has been altered.

Although in 1985, the states spent more than $30 billion on state capital outlays, the rate of investment is not keeping pace with escalating capital needs. In constant 1982 dollars, federal grants-in-aid for physical capital investment have declined from $24.7 billion in 1979 to $20.9 billion in 1987. While declining state investment in infrastructure can in part be explained by a reduction in Interstate funding, tighter state budgets are redefining capital spending as a a luxury.

This is not to suggest that capital spending on infrastructure can be foregone. Collapsing bridges, inadequate roadways and court orders to construct new prisons are a testament to the need for greater infrastructure investment. It is estimated that state and local governments will need to invest $1-2 billion in 1982 dollars to address these capital needs.

However, the changing financial environment makes these goals seem less realistic. The proliferation of measures to limit state government expenditures has reduced the states' ability to increase capital spending. The effect of these reforms has been an increase in the issuance of state revenue bonds. By 1985, the percentage of state nonguaranteed debt had grown to 80 percent of state long-term debt. In addition to these changes in state financing environments, changes in the federal tax laws have made such options as bond bank and public-private financing arrangements less appealing.

States are in large part recognizing the need for strengthening the legislative machinery for responding to infrastructure needs. Twenty-one states to date have established an independent capital facilities commission, state building commission or other independent entity responsible for recommendations on capital projects. In addition, 17 houses and 16 senates have a committee or subcommittee that focuses on capital outlays issues.

In its report, the Capital Budgeting and Finance Committee recognizes the need for state legislatures to keep comprehensive inventories on existing capital stock and to prepare long-range plans for capital needs. There are presently 30 states that keep written inventories and 23 states which prepare capital facilities needs assessment reports. Of those 36 states with long-range capital plans, most span five or six years. Iowa's and Illinois', however, cover 20 years.

One method that has been successfully utilized linking long-range and immediate capital budget plans is that employed by the State of Louisiana. A comprehensive capital budget law enacted in 1980 requires the Governor to submit a five-year program to the legislature. The legislature, in acting upon this proposal, must enact the first year as the capital budget and adopt by resolution the last four years of the program. In 1983, New York passed a comprehensive State Finance Law. This law requires a five-year capital plan to accompany the annual budget submitted to the Assembly Chairman of the Ways and Means Committee. Unfortunately, in 16 states the legislature is not involved in the preparation of a long-range plan.

Of utmost importance in long-range planning is the ability to prioritize all capital projects and identify funding sources. Currently, some 14 states rank order all capital requests across departments. This affords the legislature the opportunity to gauge the relative importance of all projects. The State of New York has developed five principles for determining priorities and directing state financing:

1. The rehabilitation of essential public facilities is given priority.
2. Investment in new facilities is judged by potential for economic development and responsiveness to changing public service requirements.
3. User fees and other special revenues are utilized rather than general revenue.
4. Obsolete capital assets are to be divested or managed by the private sector.
5. Emphasis on economic opportunities for the unemployed, minorities and women in the state's capital development programs.

In evaluating a capital project, the Michigan Legislature uses such criteria as the environment of the state, compliance with any court order, and replacement of obsolete facilities. Illinois considers economic impact and safety problems. Louisiana focuses on emergency need and cost savings. And South Carolina utilizes accreditation, matching funds and repair versus new construction.

In identifying funding sources, states should have the flexibility to select from a variety of options. States have the options in financing capital projects of paying for it now, borrowing or leasing. Idaho has established a permanent building fund to finance "pay-for-it-now" appropriations. Colorado and Oregon both use lottery proceeds for capital construction. The opponents of this type approach lodge criticisms that the cost is not spread out over the life of the asset nor is it spread among users.

Constraints on capital financing are particularly noticeable in the use of debt financing. In most states, general obligation debt cannot be incurred without voter approval. Revenue bonds, while not requiring voter approval, are usually more expensive to market than general obligation bonds. However, user fee repayment of revenue bonds makes this type of financing an attractive public policy option. Using earmarked revenues is another viable method of repayment. The State of Kentucky dedicates state-collected court fees to help finance county jail construction.

A recent innovation by the Massachusetts General Court provides enterprises and state authorities with small borrowing needs access to international financial markets. The 1987 Act allows the state's Industrial Finance Agency to coordinate bond sales of local businesses with those of state agencies. Eligible agencies include the Turnpike Authority, the Port Authority and the Water Resources Authority.

Lastly, leasing as a capital finance mechanism gives a state the option of paying in installments rather than in a lump sum. While states have historically restricted leasing to equipment, automobiles and office space, recently-enacted legislation authorizes lease-purchase and sale-leaseback agreements for university facilities, prisons and state office buildings.

Before moving on to alternative financing approaches, I would like to point out the changes in federal law which affect the issuances of state and local governments. The Tax Reform Act of 1986 effectively restricts the use of bond proceeds and the volume of new bonds. Legislatures are no longer able to rely on arbitrage earnings to cover issuance costs, and the volume caps will intensify the competition among projects.

These changes necessitate, more than ever, the active involvement of state legislators in overseeing debt management practices. In 1986, the Public Financing Management Board was created by the Rhode Island General Assembly for precisely this purpose. The Board functions as a clearinghouse to coordinate and prioritize all tax-exempt bonds issued by state and local governments.

Recent federal budget and tax reforms have also made it more difficult for local governments to finance capital projects. States continue to provide a sizable amount of infrastructure assistance to local governments. Efforts to minimize the impact of federal policies on local governments are exemplified in Utah's Wastewater Project Financial Assistance Program.

This program, established in 1983, utilizes a revolving fund mechanism to creatively leverage state funds for local use. The States of Pennsylvania and New Jersey have similar programs to assist local governments in financing infrastructure development.

Other innovative ways in which states are helping localities address infrastructure needs are interest rate buy-downs, bond issurance, state bond banks and loan guarantees. States such as Maine, Nevada, North Dakota and Vermont have made effective use of bond banks, while New Hampshire's loan guarantee program supports local water pollution control projects. A variation on the guarantee loan program is found in Oklahoma and New Jersey where a set-aside from a state revolving loan is directed to communities with low or no credit ratings.

While increasing state aid is an important means of assisting localities, easing restrictions on indebtedness and offering technical assistance are two options that should not be overlooked. Nationally state capital outlays account for 40 percent of state-local outlays; however, in Delaware, Hawaii, Kentucky, Rhode Island and West Virginia, state expenditures reach 60 percent.

In order to decrease reliance on state support, NCSL's State-Local Task Force recommends that states provide local governments with more flexibility in generating revenues. Arizona, Florida and California all provide local tax options to finance highway construction. This increased taxing authority combined with flexibility in incurring debt stand to provide localities with the tools of self-sufficiency.

Given adequate financing, the relative merits of capital requests still need to be weighed. In order for legislators to make sound judgments on these requests, alternatives to financing and alternative financing for proposed capital projects should be incorporated in the decision-making process. Estimates of operation and maintenance costs must be viewed as part of the capital investment. The Florida Public Facilities Conversion Trust Fund, created in 1980, provides state agencies with funds to convert surplus state property and schools in lieu of building new facilities. As a matter of course, the State of California reviews alternative financing techniques as it evaluates each project.

In budgeting capital expenditures, state legislatures should separate operating from capital costs, as well as planning from construction costs. This increases the level of oversight. In Louisiana, projects requiring more than one year to complete must be funded in at least two stages. Kentucky puts all $1 million plus projects to analysis by the state's engineering department.

But regardless of how we revamp the process for financing infrastructure repairs, the fact remains that inadequate funding for maintenance has greatly contributed to the state of physical deterioration in which we find our nation's bridges, roads, sewers and prisons. The tendency all-too-often has been to put money in the most visible place...something new.

Inadequate maintenance has been compounded by the effects of aging. Much of our infrastructure is reaching the end of its "design life." To combat these problems, states are beginning to look at prespecified maintenance schedules. New York now requires a maintenance schedule for all projects costing $5 million or more. The State of Maryland maintains and publishes a regular maintenance report. And the State of Michigan has identified the basic premises of a successful formula for maintenance.

Although the issue of "privitization" can sometimes be politically sensitive, particularly in the context of federal mandates, several states have used privitization or contracting out successfully for years. Twenty-eight states require competitive bidding on all capital projects. Albeit a complex public policy question, the feasibility and desirability of contracting with the private sector should be part of the capital budget review process.

As the Subcommittee examines the advantages and disadvantages of a federal capital budget, many of these recommendations for states will prove to be applicable to the federal process. As the Congress surveys the infrastructure deficiencies of this country, state programs should be explored for effective approaches.

Mr. APPLEGATE. The committee now stands adjourned.
[Whereupon, at 12:15 p.m., the subcommittee was adjourned.]

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